A GAIN MUST LIE WHERE IT FALLS:
MATCHING TAX WITH ECONOMICS IN SUBCHAPTER K

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Abstract

Society suffers efficiency costs when tax and economics are mismatched. This principle is illustrated by the tax neutrality doctrines that are the cornerstone of the U.S. international tax system and by the BEPS's efforts to combat arbitrary income shifting. While society has an interest in maximizing pre-tax income from all economic activities, self-interested taxpayers seek only to maximize their after-tax income. A sound, non-arbitrary tax policy must thus incentivize taxpayers to maximize both their pre-tax and after-tax income. This Note provides a novel efficiency analysis of the rules under Subchapter K and reveals the efficiency costs that arise when arbitrary tax liabilities sever the positive connection between pre-tax and after-tax income. It applies the insight gained from the efficiency analysis to the Treasury's various flawed efforts under Subchapter K to match tax with economics, including the Substantial Economic Effect (SEE) safe harbor and doctrines under section 704(c). The Article then explores alternatives to the Treasury's "one-size-fits-all" solution, focusing on a detailed analysis of the economic effect equivalence (EEE) test and so-called target allocations. After revealing the tension between target allocations and some of the fundamental principles of section 704 regulations, the Article presents a solution to the long-debated capital shift problem inherent in target allocations.

* J.D. 2019, Columbia Law School. I would like to thank Stuart L. Rosow, Sonia Katharani-Khan and Ivy Xiaotian Yao for their helpful comments and encouragement.

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I. INTRODUCTION: ARBITRARY TAX LIABILITIES

A famous principle of tort liability is that a loss must lie where it falls. It reflects a long-standing view that the law should not arbitrarily reallocate economic risks that parties have assumed ex ante.[1]The rationale behind this principle is that the risk of arbitrary tort liabilities may lead to inefficient ex ante allocations of realized social risks.[2] Similarly, the risk of tax liabilities that distort after-tax payoffs of transactions may incentivize transactions that fail to maximize pre-tax payoffs.[3]

Individuals generally have an incentive to engage in transactions that maximize personal wealth. The transactions that maximize personal wealth also maximize societal wealth. Therefore, in the absence of taxes, individuals pursue socially beneficial transactions in a selfish attempt to maximize their own welfare. Under a sound tax policy, the transactions that maximize pre-tax personal wealth and societal wealth will also have the highest after-tax payoff. By contrast, a tax liability or policy that mismatches the pre-tax and after-tax payoffs of a transaction (an "arbitrary" tax policy) undermines private parties' incentives to engage in socially beneficial transactions. Under an arbitrary tax policy, a taxpayer no longer has the incentive to maximize social (pre-tax) payoffs in a selfish attempt to maximize his or her own (after-tax) payoffs. For example, a 100% tax credit for all net operating losses (NOLs) is arbitrary because it subsidizes inefficient businesses and socially insures opportunistic taxpayers against pre-tax losses. To illustrate, assume a taxpayer can invest $50X in a project today and has a 50% chance of receiving $90X in a year and 50% chance of receiving nothing. Before taxes, the expected value of the transaction, ignoring time value of money, would be a social loss of $5X (50%*$90X-$50X). However, under a tax policy that provides 100% tax credit for all NOLs, and assuming that the taxpayer is in 40% tax bracket, the expected after-tax result of the transaction would be a private gain of $12X (50%*($90X-$50X)*60%). As a result, the taxpayer is incentivized to pursue a transaction that leads to a societal loss, but enables a private gain due to an arbitrary tax policy. Similarly, a 100% tax on gross income is arbitrary because most taxpayers are unwilling to earn pre-tax income that they retain 0% of after taxes. As a final example, an100% deduction for personal consumption is also arbitrary because it incentivizes taxpayers to generate lower pre-tax returns than they would in the absence of such a shelter. If John, a taxpayer in the 40% bracket, needs only $6X after-tax for self-sustenance, he can choose either to earn $10X taxed at 40% or $6X that he can fully shelter from tax via personal consumption. Though the decision to earn $10X is the socially beneficial alternative, John will choose the latter because it requires less effort for the same after-tax return.

1 *See generally* OLIVER WENDELL HOLMES, JR., THE COMMON LAW 95 (BOSTON, LITTLE, BROWN & CO. 1881) ("All the cases concede that an injury arising from inevitable accident, or…from an act that ordinary human care and foresight are unable to guard against, is but the misfortune of the sufferer…").

2 *See, e.g.*, Adams v. Bullock, 227 N.Y. 208, 210 (N.Y. 1919) (holding that the defendant, a trolley line company, should not be held liable for an "extraordinary casualty" that is "not fairly within the area of ordinary prevision"); United States v. Carroll Towing Co., 159 F.2d 169 (2nd Cir. 1947).

3 Almost all tax liabilities have efficiency costs due to the market dampening effect, which is generally referred to by economists as "deadweight loss." *See, e.g.*, Julia Kagan, *Deadweight Loss of Taxation*, INVESTOPEDIA (Dec.30, 2019) https://www.investopedia.com/terms/d/deadweight-loss-of-taxation.asp [https://perma.cc/4LZV-D5N3].

In reality, all tax liabilities incur some efficiency costs, measured by the chilling effect on the market and the shrinking volume of socially beneficial activities.[4] However, arbitrary tax liabilities can incur disproportionately large efficiency costs. In the case of the 100% tax on gross income and the 100% tax credit for NOLs, the efficiency cost is incurred because the link between pre-tax and after-tax payoffs is severed. In the case of the 100% deduction for personal consumption, the cost is incurred because the socially beneficial incentive to earn higher pre-tax returns (i.e. to achieve higher after-tax returns) is eliminated. The legal flexibility of Subchapter K increases the likelihood that such arbitrary tax liabilities and efficiency costs are imposed on taxpayers. Unlike tax policies that are clearly arbitrary, such as a 100% tax on gross income, Subchapter K's potential for arbitrariness is hidden in its complicated statutory scheme. The risk of arbitrariness is evidenced by Treasury's painstaking efforts to match tax consequences with economic arrangements in Subchapter K.[5]

This Note provides fresh insight into the design and application of complex rules in Subchapter K, which are intended to match partnership tax consequences with their corresponding economic arrangements. It examines the relationship between the regulatory anti-abuse rules, the Substantial Economic Effect ("SEE") safe harbor, and the section 704(c) doctrine, while revealing their imperfections. Specifically, Part II analyzes the efficiency costs that arise when arbitrary tax liabilities imposed by Subchapter K give rise to mismatches between tax and economics. Part III provides a detailed analysis of how the Economic Effect Equivalence test under Treas. Reg. § 1.704-1(b)(2)(ii)(i), part of the SEE safe harbor, has been applied to justify partnership allocations. It then assesses how the test should be applied in light of prolonged regulatory uncertainties, given its importance. Part IV uses insights from Parts II and III to address the long-debated but unresolved issue of partnership "target allocations," with a focus on the capital shifting problem inherent in preferred return allocations.

II. EFFICIENCY COSTS DUE TO TAX-ECONOMICS MISMATCHES IN SUBCHAPTER K

A. The Flexibility of Subchapter K

Congress intended for Subchapter K to facilitate joint business and investment activities by permitting flexible economic arrangements without triggering entity-level taxes.[6] Thus, Subchapter K provides significant flexibility for partners to allocate among themselves the benefits, burdens and risks of partnership activities. A partnership is not subject to entity-level tax.[7] Instead, each partner must separately take into account his distributive share of partnership items.[8] Section 704 and related regulations permit a partner's distributive share to be determined by the partnership agreement. If such allocations lack substantial economic effect, the relevant partnership items will be reallocated, solely for tax purposes, in accordance with the partner's interest in the partnership determined under all

[4] *Id.*
[5] *See* Part II.A, *infra*. The reader may develop a sense of Treasury's "painstaking efforts" by looking at the length and complexity of section 704 regulations. *See generally* Treas. Reg. §1.704-1.
[6] Treas. Reg. §1.701-2(a).
[7] I.R.C. § 701.
[8] *Id. See also* I.R.C. § 702(a).

facts and circumstances.[9] The partnership agreement need not provide that partnership items be allocated in proportion to each partner's capital contribution to the partnership.[10]

To provide even more flexibility, Subchapter K permits partners to modify the partnership agreement and make special allocations of partnership items for the taxable year up to the time prescribed by law (excluding extensions) for filing the partnership's tax return.[11] Such flexibility is also in line with Congress' intent to establish partnerships as vehicles for pooling resources for productive uses without triggering gain or loss.[12]

It is easy to see how the significant flexibility of Subchapter K, in the absence of anti-abuse rules, may lead to disproportionately large efficiency costs. As with the taxpayers incurring arbitrary tax liabilities discussed in Part I, partners seeking to maximize their after-tax payoffs may from time to time be incentivized to go against the socially beneficial goal of maximizing pre-tax payoffs. For example, the partners may be incentivized to shift the tax consequences of economic activities, whether related or unrelated to the partnership's business, among themselves without shifting the underlying economic activities.[13] If this is the case, the government will unintentionally subsidize inefficient businesses (as in the case with a 100% tax credit for NOLs) and will hinder the proper functioning of capital markets due to the use of tax shelters (as in the case with a 100% deduction for personal consumption).

B. The Problem of Unintended Government Subsidies

To understand the efficiency cost of Subchapter K in terms of unintended government subsidies, assume that the partners initially have unlimited flexibility in allocating partnership items for tax purposes without regard to how they share those items economically. Suppose an individual, A, is operating a profitable business with $100X capital at an annual pre-tax return of 10%. To expand his business, A is considering attracting capital owned by B and C. Each would contribute $100X each, and both lack expertise in A's business. A is uncertain as to whether B and C will hold a debt or equity interest in the business. For simplicity, assume that A is in the 40% tax bracket, while B and C pay no tax because of favorable tax attributes such as NOL carryovers.

Debt form of transaction: If B and C come in as creditors for a 5% annual pre-tax return on their investment, A will now have $300X capital and retain exclusive control over the

9 I.R.C. § 704(a) & (b); Treas. Reg. § 1.704-1(b)(1)(i). *See also* S. COMM. ON FINANCE, 98TH CONG., 2D SESS., REP. ON DEFICIT REDUCTION ACT OF 1984, 213.

10 *See* STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, AT 94. As a comparison to S corporation rules, see I.R.C. §1366(a) (requiring pro rata allocation of an S corporation's items of income, loss, deduction, or credit to its shareholders).

11 *See* STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAXATION, *supra* note 10; *see also* Section 761(c).

12 *See* S. COMM. ON FINANCE, 98TH CONG., 2D SESS., REP. ON DEFICIT REDUCTION ACT OF 1984, 214. *See also supra* note 6.

13 For a recent example, see TIFD III-E Inc. v. United States, 342 F. Supp. 2d 94 (D. Conn. 2004), rev'd, 459 F.3d 220 (2d Cir. 2006), also known as the *Castle Harbour* case. In that case, the taxpayers attempted to shift taxable gain to a foreign tax-neutral partner while the gain would have been taxable to the U.S. partner. Though the allocations were upheld by the district court, the decision was ultimately reversed by the Second Circuit.

business. Because of his specialized knowledge in the business and unhindered control over its operations, the business will continue to generate a 10% annual pre-tax return. Assuming interest expense is fully deductible, the after-tax return on investment for the parties is as follows:

Party	Payoff
A	$12X
B	$5X
C	$5X
Total for Private Parties	$22X
U.S. Government	$8X
Total for All Parties	$30X

A: ($300X * 10% - 5% * $200X) * (1-40%)
B: ($100X * 5%)
C: ($100X * 5%)
U.S. government: ($300X * 10% - 5% * $200X) * 40%

Equity form of transaction: If B and C have management rights and come in as general partners, assume that their lack of business expertise and the resulting management inefficiencies means that the business (now Partnership ABC) can only generate a 9% annual pre-tax return on the same $300X capital. Despite the lower pre-tax return, A will take advantage of the partnership's unlimited flexibility to make special allocations and allocate all pre-tax profit to B and C solely for tax purposes, while their actual economic entitlement remains unchanged. Because B and C pay no tax, and A now has no taxable income from the business, the after-tax payoff for the parties is as follows:

Party	Payoff
A	$17X
B	$5X
C	$5X
Total for Private Parties	$27X
U.S. Government	0
Total for All Parties	$27X

A: ($300X * 9% - 5% * $200)
B: ($100X * 5%)
C: ($100X * 5%)
U.S. government: 0

B and C will generally be indifferent to the debt and equity forms of the transaction because they expect a 5% after-tax return in both cases. However, A will strongly prefer the equity form of the transaction due to the tax savings, and may provide B and C with management rights and a higher than 5% return as "sweetener" for participation in the income shifting scheme. Although A knows that B and C are not familiar with the business and that their involvement in the business leads to an efficiency cost, A will not act as a "gatekeeper" because he is able to transfer such costs to the U.S. government. In other words, although the debt form of the transaction is more socially beneficial, the unlimited flexibility in allocating partnership items incentivizes A to choose the equity form.

In this example, the U.S. government provides an $8 unintended subsidy (in terms of an implied tax credit) for the private parties to operate an inefficient business: a subsidy of $3 to fully absorb the efficiency cost, and an additional $5 subsidy as a "sweetener" to continue operating the business inefficiently. The tax policy in this case thus permits an increase in the after-tax payoff for the private parties (from $22 to $27) even when the pre-tax payoff for all parties decreases from $30 to $27. In other words, since the parties can pursue a higher after-tax payoff simply by changing the form of the investment, there is no incentive to also maximize the pre-tax payoff. This is an example of an arbitrary tax liability as defined in Part I of this Note:[14]one that severs the connection between pre-tax and after-tax payoffs, subsidizes inefficient businesses, and potentially squeezes out efficient businesses.[15]

Subchapter K's attempts to eliminate such arbitrary tax liabilities by matching taxes with economics.[16] To illustrate with the same example, under Subchapter K, the U.S. government can instead require that whoever is allocated partnership income for tax purposes must actually be entitled to such income. As a result, A will be taxed at a 40% rate on $17 of partnership income because he is actually entitled to it. The parties' payoffs will be as follows:

Party	Payoff	
	Debt Form	Equity Form
A	$12X	$10.20X
B	5X	5X
C	5 X	5X
Total for Private Parties	$22X	$20.20X
U.S. Government	$8X	$6.80X
Total for All Parties	$30X	$27X

The table above shows three things. First, the U.S. government and private parties now share the $3X efficiency cost under the equity form of transaction in proportion to A's tax rate, or 40/60 (U.S. government: $1.2X, A: $1.8X). In other words, the U.S. government now only provides an implied deduction of $3X for the efficiency cost, by not taxing the $3X as imputed income. As a result, the $8X unintended subsidy in terms of an implied tax credit is fully eliminated. Second, the new tax policy is non-arbitrary because it's no longer possible for private parties to pursue a higher after-tax payoff given the same or even lower pre-tax payoff. At the partnership level, the $3X efficiency cost can only generate $1.2X in tax savings. Thus, the partnership is better off avoiding the efficiency cost. At the partner level, for each dollar shifted from A to B or C, A loses a dollar but only receives $0.4X in tax savings., and therefore

14 Another way to describe this tax policy of allowing unlimited allocations of partnership items solely for tax purposes is that it is not "neutral." A neutral tax policy should stay in the background and allow non-tax market forces to govern a transaction. *See* RICHARD L. DOERNBERG, INTERNATIONAL TAXATION IN A NUTSHELL§ 1.04(9th ed. 2012) (stating that the goal of a tax system in general is "the implementation of a tax-neutral set of rules that neither discourage nor encourage particular activities.").
15 *See* Part II.C, i*nfra.*
16 *See supra* note5.

A too is better off without shifting the income. Third, A will now have an incentive to maximize the pre-tax payoff from the business, which leads to a socially beneficial result.

C. The *Orrisch* Case and The Problem of Capital Market Failure

To visualize how an arbitrary tax liability may squeeze out efficient businesses by disturbing normal market forces in capital markets and how it exacerbates the tax shelter effect of accelerated depreciation, consider an early case on the SEE safe harbor, *Orrisch v. Commissioner*.[17] The Orrischs and the Crisafises formed a partnership to purchase and operate two apartment houses. To better utilize the accelerated 150% of straight-line depreciation, the parties agreed to allocate all depreciation to the Orrischs (for both tax and book purposes) to shelter their substantial income from unrelated sources. The parties combined this with a special allocation (for both tax and book purposes) of gain on sale of the depreciated properties in the future to the Orrischs to the extent of their previously allocated depreciation. They shared all other partnership items 50/50.

On the surface, it was not possible for the Orrischs to increase their after-tax payoff without increasing their pre-tax payoff since they would lose their entitlement in liquidation as they deduct additional depreciation. However, as the court correctly observed, the Orrischs would eventually be compensated for such loss by the special allocation of gain on the sale of the depreciated properties. Assuming that such properties preserve their value, the Orrischs would be fully restored to their original economic position as if no special allocation had ever been made. Of course, the Orrischs assumed the risk that the partnership properties may lose value. But the facts and circumstances indicated that they would not have agreed to the special allocation unless they believed that the present value of expected net tax savings outweighed the present value of loss from any expected decline in property value. Arrangements like this interfere with the goal of a properly functioning capital market, i.e. to allocate capital to the party that can use it to generate the greatest value. For example, if another party expects a smaller decline in property value because of its greater ability to preserve property value, but is unable to generate enough net tax saving from the investment, the property will end up in the hands of inefficient investors such as the Orrischs.

As a variation on the facts of the case, assume that the partnership formed by the Orrischs and the Crisafises (Partnership OC) is in a bidding contest against another partnership (Partnership AB) for an item of depreciable property. Partnership OC can sell the property for $100,000 after fully depreciating it (with no salvage value). However, Partnership AB, which can better utilize, maintain and improve the property, can sell it for $130,000 after full depreciation. Assume a five-year investment horizon, five-year useful life, an annual discount rate of 10%, a tax bracket of 40% for all the partners, and a perpetuities valuation model to calculate the present value of future payoffs for both parties. Assume further that the Orrischs have substantial personal income to fully utilize any excess depreciation, while the Crisafises and the partners in Partnership AB have no other income to utilize against any excess

[17] *See* Orrisch v. Commissioner, 55 TC 395 (1970). The *Orrisch* case may come out differently under current section 704 regulations, under which a partnership property's fair market value is presumed to be its adjusted tax basis for purposes of determining whether several partnership allocations are "transitory" and thus without substantial economic effect. *See* Treas. Reg. § 1.704-1(b)(2)(iii)(c). *See also* Treas. Reg. 1.701-2(d), Ex. 6(i). However, the insight provided by the *Orrisch* court is still helpful in understanding Subchapter K's logic of matching taxes with economics.

depreciation. The maximum bidding price that Partnership AB is willing to pay, PMAX(AB), is approximately $143,000 (ignoring time value of money).[18]

Similarly, as explained in footnote 18, Partnership OC's annual income from the property is assumed to be $10,000, or $100,000 * 10% under the perpetuities model. If a court permits the special allocation, since the Orrischs are in the 40% tax bracket, the maximum bidding price by Partnership OC will be PMAX(OC), which is equal to the sum of the expected income from the property and the net tax savings from the special allocation scheme.[19] Solving for PMAX(OC) gives $150,000. Consequently, since PMAX(OC) is greater than PMAX(AB), Partnership OC will outbid Partnership AB to receive the property. However, this capital allocation is economically inefficient because Partnership AB is better at utilizing, maintaining and improving the property. The efficiency cost of $45,000 (ignoring time value of money)[20] stems from the tax shelter effect of depreciation provided by a tax policy that permits the special allocation proposed by the Orrischs.

To exacerbate the issue, Partnership OC may have borrowed on a nonrecourse basis to acquire the property, and the property may be entitled to immediate expensing of its acquisition cost.[21] Assume, in this extreme case, that Partnership OC incurred $145,000 of nonrecourse debt to outbid Partnership AB and acquire the property. The property has a useful life of five years and will be worth $100,000 at the end of its useful life, but the Orrischs are entitled to an immediate 100% cost recovery deduction. Assume that income from the property is just enough to cover interest payments, that all interest payments are deductible and that the creditor does not anticipate any decline in property value due to information asymmetries. The debt will mature after five years and will have a principal balance of $145,000 at maturity. Since the property will be worth only $100,000 at maturity, Partnership OC will abandon the property to the creditor in full satisfaction of the debt, and the Orrischs will be allocated the $145,000 partnership minimum gain.[22] The pre-tax payoff for Partnership OC is zero, because it has no equity in the property and all income before interest and tax (EBIT) derived from the property is paid to the creditor as interest. However, the after-tax payoff for Partnership OC is

[18] Under the perpetuities model, a $130,000 property value and 10% annual discount rate implies a perpetual annual cash flow of $13,000, or $130,000*10%. Assuming that Partnership AB also generates $13,000 annual income from this property during the five-year investment period, the maximum payoff from the investment for Partnership AB is (5*$13000 + 60%*$130,000), or $143,000. For an introduction to perpetuities valuation, see RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 27-28 (12th ed. 2017).

[19] Mathematically, PMAX(OC) =100,000 * 0.6 + 0.4 * PMAX(OC) – 0.4*5*$10,000 + 5*$10,000

[20] This is calculated as follows: 5*($13,000 - $10,000) + $130,000 - $100,000.

[21] For immediate expensing of certain capital expenditures, see I.R.C. § 179. *See also* I.R.C. § 168(k) (bonus first year depreciation). Both rules potentially lead to a mismatch between tax deductions and economic income, and the result can be an increase in expected after-tax yield from the property given the same expected pre-tax yield. *See* Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1598 (1979) (explaining the immediate-deduction/yield-exemption equivalence); MICHAEL J. GRAETZ, DEBORAH H. SCHENK, ANNE L. ALSTOTT, FEDERAL INCOME TAXATION, PRINCIPLES AND POLICIES 314-318 (8th ed. 2018).

[22] For the rules governing the allocation of nonrecourse deductions and minimum gain chargeback, see Treas. Reg. §1.704-2(a) to (g). *See also* Crane v. Comm'r., 331 U.S. 1 (1947); Comm'r. v. Tufts, 461 U.S. 300 (1983) (minimum gain for the difference between the amount of nonrecourse debt secured by a property and the adjusted basis must be recognized in a sale or exchange, regardless of fair market value); Boris I. Bittker, *Tax Shelters, Nonrecourse Debt, and the* Crane *Case*, 33 TAX L. REV. 277, 283 (1978) ("[*C*]*rane* laid the foundation stone of most tax shelters . . . .").

positive in present value terms. The Orrischs are entitled to a depreciation deduction of $145,000 in the year of acquisition, and assuming that the property is fully deductible,[23]they will have a cash inflow of $58,000; after five years, the Orrischs will have a cash outflow of the same amount (assuming the same tax rate) because of the realization of minimum gain. This is equivalent to taking out an interest-free loan from the Treasury for five years. Assuming an annual discount rate of 10%, the Orrischs' after-tax payoff is $21,987.[24] Even worse, since the Orrischs have incurred zero after-tax cost in the property (entirely financed by non-recourse debt), the after-tax return on investment is positive infinity.[25]

Alternatively, if a court rejects the special allocation and reallocates the excess depreciation 50/50 between the Orrischs and the Crisafis, as the court here correctly did, the following relation holds: PMAX(OC) – (100,000 * 0.6 + 0.6*5*$10,000 + 0.4 * 0.5* PMAX(OC)) = 0. Solving for PMAX(OC)gives $112,500. Since PMAX(OC) is now smaller than PMAX(AB), Partnership AB will outbid Partnership OC, and the property will go to the party that can use it more efficiently.

As the two examples show, a tax policy that allows unconstrained partnership allocations solely for tax purposes severs the connection between pre-tax and after-tax payoffs. Therefore, such a policy undermines the socially beneficial incentives to maximize after-tax payoffs through the maximization of pre-tax payoffs. Such a tax policy is thus arbitrary as defined in Part I. If a taxpayer can consistently and predictably increase expected after-tax payoffs given the same or even lower expected pre-tax payoffs, the consequence is an unintended subsidy to inefficient businesses, as well as increased inefficiency in capital markets.

D. Allocation of Nonrecourse Deductions and the Treasury's Solution

The *Orrisch* and *Tufts* doctrines suggest that any allocation of partnership nonrecourse deductions should not be respected for tax purposes since by definition it mismatches tax and economics.[26] A nonrecourse deduction is generally a deduction attributable to nonrecourse financing, such as a depreciation deduction from basis obtained through nonrecourse acquisition mortgage debt.[27] The creditors, not the taxpayer, assume the economic burden of a nonrecourse deduction.[28] Similarly, an allocation of gain attributable to a decrease in partnership minimum gain (or *Tufts* minimum gain at the partnership level) for tax purposes is

[23] The deduction may be limited by the "at-risk" rule. *See* I.R.C. § 465.
[24] The number is calculated as the cash inflow today less the present value of the cash outflow in five years: $58,000 – $58,000/(1+0.1)^5.
[25] *See, e.g.*,GRAETZ, SCHENK &ALSTOTT, *supra* note 21, at 310-311, 364 (discussing tax arbitrage opportunities where the Code allows immediate expensing of the cost of assets). As an example of such tax arbitrage, assuming a taxpayer in the 40% bracket borrows at 5% annually (economically equivalent to short-selling a 5% bond) and buys an asset of the same risk which generates a 5% annual return. If the interest expense is fully deductible and no immediate expensing is allowed on the asset, both the pre-tax return and after-tax return are zero. However, if immediate expensing is allowed, the taxpayer's cost of borrowing would be 4% but the after-tax yield on the asset would be 5% due to the immediate-deduction/yield-exemption equivalence. *See* GRAETZ, SCHENK & ALSTOTT, *supra* note 21. Therefore, the taxpayer can arbitrage the 1% difference by engaging in the transaction.
[26] This observation is also supported by current regulations. *See* Treas. Reg. § 1.704-2(b)(1) ("Allocations of . . . ("nonrecourse deductions") cannot have economic effect because the creditor alone bears any economic burden that corresponds to those allocations.").
[27] For the definition of nonrecourse deductions, *see* Treas. Reg. § 1.704-2(c).
[28] *See* Treas. Reg. § 1.704-2(b)(1).

always mismatched with economics since the partners are relieved from an economic burden that doesn't exist in the first place (e.g. when the encumbered property is surrendered to the creditor or transferred to a third party).[29]

Since a partner who is allocated a nonrecourse deduction will be allocated partnership minimum gain in the same amount when it is realized,[30] an allocation of a nonrecourse deduction is exactly what the *Orrisch* court described as "a trade of tax consequences."[31] Without restrictions, a partnership tax shelter involving nonrecourse financing, like the one mentioned in Part II.C, will give a taxpayer zero pre-tax return but an after-tax return of positive infinity.[32] The Treasury's strategy is a two-part solution.

First, by explicitly stating that an allocation of nonrecourse deduction and partnership minimum gain can never match the economics,[33] the Treasury can prescribe less "safe-harbored" and more rigid rules to govern such allocation, and a taxpayer cannot justify her own allocation on the ground that it matches the economics.

Second, to reduce the possibility that a nonrecourse deduction will offset economically unrelated income for tax purposes, which is the essence of a tax shelter,[34] the Treasury requires nonrecourse deductions to be allocated in a way that are "reasonably consistent" with other allocations related to the same encumbered property that *do* match the economics.[35] By combining nonrecourse deductions with related partnership items in an allocation, partners who want to allocate nonrecourse deductions in a certain way may need to alter another allocation, which eventually alters the economic entitlement of each partner. In addition, since the allocation of net income from operation of the encumbered property, before considering nonrecourse deductions, usually matches each partner's economic entitlement,[36] an allocation of nonrecourse deductions that is tied to the allocation of such income reduces the availability of tax shelters. This is because it is now harder to create an artificial net loss for a partner through a special allocation of nonrecourse deductions.[37] Treasury's position on the allocation of partnership nonrecourse deductions appears to be a compromise between complying with the *Tufts* doctrine and reducing its harmful impact during partnership allocations. Nevertheless, it often fails to take a similar position on other allocations when the same harmful impact is present. Part III of this Note will perform a detailed analysis of the Treasury's efforts to match tax results with economics in partnership allocation context, discuss the inherent uncertainty, inefficiency, and inconsistency, and suggest an improvement. Part IV of this Note will apply the insight from this analysis to the so-called "target allocations" and propose a solution to the long-debated capital shift problem in target allocations with preferred returns.

29 *See* Treas. Reg. § 1.704-2(b)(2).
30 Treas. Reg. § 1.704-2(f), (g).
31 Orrisch v. Comm'r., 55 T.C. 395, 403 (1970).
32 *See* Part II.C., *supra*.
33 Treas. Reg. § 1.704-2(b)(1)–(2).
34 For a brief introduction to tax shelters, see Julia Kagan, *Tax Shelter*, INVESTOPEDIA (12/30/2019), https://www.investopedia.com/terms/t/taxshelter.asp [https://perma.cc/4LZV-D5N3].
35 Treas. Reg. § 1.704-2(e)(2).
36 *See* Treas. Reg. § 1.704-2(e)(1), (4).
37 In the nonrecourse financing example in Part II.C,, if the Orrischs and the Crisafis agree to allocate net income before nonrecourse deduction 50/50, the nonrecourse deduction from the immediate expensing must also be allocated 50/50. This reduces the possibility that the Orrischs can obtain a net loss from the nonrecourse deduction and use it to offset income unrelated to the partnership's business.

III. THE SUBSTANTIAL ECONOMIC EFFECT SAFE HARBOR: ONE SIZE FITS ALL?

To provide a statutory link between the after-tax payoff and the expected pre-tax payoff in the partnership context, Subchapter K requires all partnership allocations to either be made "in accordance with the partner's interest in the partnership," or have "substantial economic effect" ("SEE").[38] The former, known as "partner's interest in the partnership test" ("the PIP test"), is a facts and circumstances test in determining the economic substance of an allocation, and its outcome can be highly uncertain.[39]To reduce the uncertainty, the Treasury promulgates three alternatives to provide a safe-harbor enabling most partnership allocations to qualify under the SEE test — the primary test, the alternate test for economic effect, and the economic effect equivalence test.[40] An allocation satisfying either one of these alternatives is deemed to have an "economic effect." If such economic effect is also "substantial" under the Regulations, the allocation will be respected for tax purposes for matching the economics.[41] On the other hand, if an allocation fails to satisfy any of the alternatives or if the economic effect is insubstantial, the relevant partnership item will be reallocated solely for tax purposes to reflect the parties' real economic arrangement, i.e., "in accordance with the partner's interest in the partnership."[42]

A. Economic Effect

Not surprisingly, the Regulation defines an allocation as having "economic effect" if there is a matching of actual economic benefit or burden with the allocation for tax purposes of partnership items that generate such benefit or burden.[43] That is, an allocation for tax purposes will be respected only if the relevant partners are better-off or worse-off in terms of expected pre-tax payoff from partnership activities. Using the problem of the unintended subsidy in Part II.C. as an example, in order for the allocation of all $27X pre-tax income to B and C to have economic effect, they must be actually entitled to the $27X in a liquidation.[44]As a result, A is worse-off by $27X pre-tax but can only generate tax savings equal to a fraction (A's marginal tax rate, or 40%) of $27X. Thus, under the economic effect requirement, if A desires higher after-tax income for himself from partnership activities, he must cause the partnership to earn higher pre-tax income using his knowledge and expertise. This aligns A's personal interest with the interest of society and eliminates the $3X efficiency cost.

Under the primary test, an allocation is treated as having economic effect if: (1) the partners' capital accounts are maintained to reflect any changes in economic entitlement to

[38] *See* I.R.C. § 704(b); Treas. Reg. § 1.704-1(b)(1)(i).
[39] To satisfy the PIP test, an allocation must be made "in accordance with the partner's interest in the partnership." *See* I.R.C. § 704(b). The regulations specify four factors to be considered in determining a partner's interest in the partnership, including relative contributions, share of economic profit or loss, cash flow rights and other non-liquidating distributions, right, and entitlement to liquidating distributions, but otherwise provides little guidance on how those factors should be weighted and applied. Treas. Reg. § 1.704-1(b)(3)(ii). *See also* William G. Cavanagh, *Targeted Allocations Hit the Spot*, 129 TAX NOTES 89, 96(Oct. 4, 2010) (stating that the lack of guidance on the PIP test indicates the drafters' desire to encourage taxpayers' reliance on the SEE safe harbor).
[40] Treas. Reg. § 1.704-1(b)(2)(ii)(b), (d),(i).
[41]Treas. Reg. § 1.704-1(b)(1)(i), (b)(2)(i).
[42] Treas. Reg. § 1.704-1(b)(1)(i).
[43] Treas. Reg. § 1.704-1(b)(2)(ii)(a).
[44] *See, e.g.*,Treas. Reg. § 1.704-1(b)(5),Ex.(1)(i)–(ii).

partnership net assets as a result of partnership allocations; (2) each partner will receive her economic entitlement in liquidation; and (3) a deficit in a partner's capital account balance, representing the amount owed to the partnership because of events such as distribution, allocation of partnership expense, or loss or assumption of partnership liabilities,[45] triggers an unlimited obligation (known as "deficit restoration obligation," or "DRO") for the partner to reimburse the partnership in liquidation.[46] Thus, the SEE safe harbor uses the capital account balance to measure the partner's economic entitlement to the partnership's net assets or the partner's obligation to make additional contributions to the partnership.[47]

Under the alternate test for economic effect, if the partnership agreement otherwise satisfies the primary test but for the fact that some or all partners do not have an unlimited DRO, which can be common for limited partnerships or limited liability corporations, an allocation still has economic effect upon the satisfaction of two conditions. First, the allocation cannot create or increase a deficit in capital account balances in excess of any limited DRO. Second, the partnership agreement must have a provision (known as "qualified income offset," or "QIO") that requires offsetting allocations to be made as quickly as possible to eliminate any capital account deficit caused by certain events such as an unexpected partnership distribution.[48] This may require an allocation of partnership gross income or gain, given that the QIO regulation specifically refers to gross income in the Treasury regulations.[49]

Interestingly, to prevent partnerships from manipulating the timing of distributions to fit an allocation of deduction into the alternate test (for example, by deferring a distribution to the beginning of the next year so that a partner has a greater capital account balance to absorb a deduction in the current year), the Regulation requires that a partner's capital account balance be reduced by the excess of expected future distributions over the reasonably expected future offsetting increases in the partners' capital account balances.[50]

B. Mismatch Between Tax and Economic Under the Treasury's Capital Account Approach

1. *The "Ceiling Rule" Issue*

A partner's capital account balance can only be adjusted when certain economic activities promulgated by the Treasury occur. It is thus possible that an economic arrangement cannot be translated into a capital account balance because it is not included in scope of the

45 *See* Treas. Reg. § 1.704–1(b)(2)(iv)(b) (providing rules for decreasing partners' capital accounts).
46 Treas. Reg. § 1.704–1(b)(2)(ii)(b)(3). *See also* Treas. Reg. § 1.704–1(b)(2)(ii)(c) (describing a partner's deemed obligation to restore deficit even in absence of express obligation to do so).
47 *See* Treas. Reg. § 1.704–1(b)(2)(ii) (requiring maintenance of partners' capital accounts according to Treas. Reg. § 1.704–1(b)(2)(iv)). *See also* Treas. Reg. § 1.704–1(b)(2)(iv) (requiring capital account balances to be increased or decreased by allocations or events which change the partner's economic entitlement to the partnership's net assets).
48 Treas. Reg. §1.704–1(b)(2)(ii)(d)(1) to (3). See "flush language" included in Treas. Reg. § 1.704–1(b)(2)(ii)(d) for explanation of qualified income offset, or QIO.
49 *See* "flush language" in Treas. Reg. § 1.704–1(b)(2)(ii)(d) (providing that a partnership agreement contains a QIO only if a partner receives allocations of income and gain, *including gross income*, to cure certain unexpected adjustments, allocations or distributions that lead to a deficit balance in the partner's capital account).
50 Treas. Reg. §1.704–1(b)(2)(ii)(d)(6).

Treasury's listed activities.[51] In other words, except under the listed situations, the Regulation prohibits partners from voluntarily adjusting their respective capital account balances by any "hypothetical" gain or loss allocated.[52] This can be understood as an inherent "ceiling rule" in the Treasury's capital account approach.[53] The "ceiling rule " applies even if doing so would lead to capital account balances that better reflect the partners' entitlements on liquidation.

A mismatch between tax and economics results when, for example, the liquidating distributions must deviate from capital account balances in order to reflect the partners' economic agreement, but no corresponding tax gain or loss can be allocated at the time of liquidation to match tax with economics due to the "ceiling rule."[54] For example, suppose a partnership agreement between A and B initially provides for a 70/30 allocation of all partnership items, but requires an 80/20 allocation of liquidating distributions if A completes at least 2,000 hours of professional service to the partnership by the time of liquidation.[55] A and B cannot readjust the capital account balances at liquidation to reflect the 10% difference if there is no gain or loss. Moreover, they cannot allocate a fictitious partnership-level gain to A and a corresponding loss to B due to the "ceiling rule." Therefore, the capital account balances will fail to reflect the economics of transaction when liquidation distributions are shared according to the 80/20 allocation. Another example of this type of mismatch is the capital shift problem in an economic arrangement involving preferred return on capital, to be discussed in Part IV.B.

2. *The Book-Tax Disparity and Section 704(c)*

Certain revaluation events, such as admission of new partners or distribution of property, will also trigger a mismatch that creates a book-tax disparity in tracked basis.[56] Consider the following example.[57]

Example One

The balance sheet of Partnership ABC as of 12/31/20X1 is as follows:

[51] For the rules governing capital account adjustments, see Treas. Reg. §1.704–1(b)(2)(iv), permitting or mandating adjustment to a partner's capital account balance under situations like contribution of capital, certain assumptions of partnership liabilities, and allocation of partnership income or loss, including gain or loss from revaluation of property and distribution. *See* Treas. Reg. §1.704–1(b)(2)(iv)(b), (c), (f), (g).

[52] *See, e.g.*, Treas. Reg. § 1.704–1(b)(2)(iv)(f) (suggesting that capital account balances may be adjusted for revaluations of property that are in the form of unrealized or "fictitious" gains or losses only under limited circumstances).

[53] *See* discussion Part IV. A., *infra*.

[54] *See, e.g.*, Daniel S. Goldberg, *The Target Method for Partnership Special Allocations and Why It Should Be Safe-Harbored*, 69 TAX LAW. 663, 702-706 (2016).

[55] For a similar example, see *id*. at 702-703.

[56] For revaluation of partnership properties, see Treas. Reg. § 1.704–1(b)(2)(iv)(e)(1) regarding mandatory revaluation when partnership property is distributed. See Treas. Reg. § 1.704–1(b)(2)(iv)(f) for the provision of optional revaluation under limited circumstances. See Treas. Reg. § 1.704–1(b)(4)(i) for the requirement that Section 704(c) doctrine govern the allocation of tax items after revaluation.

[57] For the purposes of this example, assume that none of the partnership properties are covered by Section 751 or related regulations. Thus, there is no "mixing-bowl" issue. *See* I.R.C. § 751(b).

	Tax Basis	Book Value	Fair Market Value
Blackacre	$100X	$100X	$800X
Whiteacre	200X	200X	400X
Blueacre	300X	300X	1,200X
A's capital	300X	300X	1,200X
B's capital	150X	300X	600X
C's capital	150X	300X	600X

Suppose that on December 31, 20X1, the partnership distributes Whiteacre to B. Prior to distribution, the partners shared all partnership items with a 50/25/25 allocation. After the distribution, B's share is reduced to 10%. Whiteacre is revalued at the fair market value of $400X, and the resulting revaluation gain of $200X is allocated according to the partnership agreement (i.e. $100X to A, $50X to B, and $50X to C).[58] Suppose a section 754 election is made and an upward basis adjustment of $50X is available for Blackacre and Blueacre.[59] If Partnership ABC is liquidated immediately by selling all remaining properties at fair market value, the tax consequences will not reflect the parties' economic arrangement, resulting in a mismatch. After the sale, the partnership has total cash of $2,000X and a gain of $1,550X.[60] Since A, B, and C now share partnership items based on a 60/30/10 split, the $1,550X gain must be allocated accordingly to A, B, and C for both book and tax purposes. As a result, A's economic gain from partnership activities is $900X,[61] but A's gain for tax purposes is $930X,[62] creating a mismatch of $30X that is not cured by the section 754 election. Similarly, B has an economic gain of $450X compared to a tax gain of $465X, and C has an economic gain of $450X compared to a tax gain of $405X.

The above example shows an inherent problem in the Treasury's capital account method: in a complex transaction, the capital account adjustment rules may be totally inadequate for matching the tax consequences at the time of allocation with the economic consequences at liquidation.[63] In Example One, because the partners do not elect to revalue Blackacre and Blueacre when Whiteacre is distributed to B,[64] section 704(c), which generally matches tax consequences after certain partnership-level changes to related economic activities

58 *See* Treas. Reg. § 1.704–1(b)(2)(iv)(e)(1) (providing that upon a distribution of property, capital accounts must be adjusted to reflect gain or loss inherent in the property as if there were a taxable disposition of the property at fair market value on the date of distribution).

59 This upward basis adjustment is due to $50X basis reduction of Whiteacre owned by B. *See* I.R.C. § 732(a)(2). Without the adjustment, the same $50X will be taxed twice when B sells Whiteacre and when the partnership sells the remaining asset. For an election under section 754 to adjust basis, *see* I.R.C. § 734(b); I.R.C. § 754; Treas. Reg. § 1.734–1(a), (b); Treas. Reg. § 1.754–1.

60 The sum of the difference between the tax basis and fair market value of both Blackacre and Blueacre, minus the $50X upward basis adjustment.

61 The fair market value of A's partnership interest, $1,200X, minus A's tax basis in such interest, $300X.

62 The partnership's $1,550X tax gain multiplied by A's 60% interest.

63 *See, e.g.*, Goldberg, *supra* note 54, at 706 (arguing that sometimes the economic deal of the partners is too complicated for the Treasury's capital account method).

64 Such revaluation is optional rather than mandatory. *See supra* note 52; Treas. Reg. § 1.704–1(b)(2)(iv)(e)(1) (requiring revaluation of the distributed property only).

prior to such changes, does not apply.[65] When Blackacre and Blueacre are sold, the Treasury's method fails to properly account for economic activities prior to the distribution from which the gain has accrued. This problem can be solved by making a revaluation of all partnership properties mandatory whenever a property distribution happens. However, such a solution may significantly increase the administrative cost of operating a partnership.

Professor Daniel S. Goldberg identified factors such as accountant errors in allocation calculations that result in mismatches between tax and economics under the Treasury's method.[66] His suggested solution is to safe-harbor an alternative method, commonly known as the target method of allocations (hereinafter "target allocations").[67] As will be discussed in Part IV.A., implementing this method is more complicated than it may seem, and doing so may cause new problems as it solves the old ones.

3. The Abuse of DRO and Bottom Dollar Payment Obligations

A different type of tax-economics mismatch under the Treasury's capital account method occurs through the abuse of the deficit restoration requirement, or DRO.[68] A DRO is an obligation of a partner to restore her negative capital account balance by making an additional contribution to the partnership, triggered by the liquidation of her partnership interest.[69] Because capital account deficits need to be restored only at liquidation and the associated tax deduction may be claimed immediately against unrelated income, the partnership can be structured in a way that actual liquidation will never occur.[70] This creates a risk that the tax mismatches the economics in present value terms.[71] This problem is exacerbated by the current regulations in three ways. First, the regulations do not consider whether a partner actually has the financial resources to honor a DRO. Additionally, the regulations presume that the value of partnership property is equal to its adjusted basis when determining substantiality of an allocation's economic effect. Finally, the regulations allow

65 Alternatively, if the partnership elects to revaluate all properties immediately before the distribution, the $1,550X will be revaluation gain and section 704(c) doctrine can potentially ensure that in the subsequent liquidation, A, B and C will be allocated a tax gain of $900X, $450X and $250X, respectively. *See* I.R.C. § 704(c); Treas. Reg. § 1.704-1(b)(2)(iv)(f)(4) (providing that adjustments to partners' capital accounts for gains, losses and cost recovery deductions on revalued property must be made as required by Section 704(c)); Treas. Reg. § 1.704-1(b)(4)(i) (providing that cost recovery deductions, gain and loss on revalued property must be allocated among the partners to take into account the difference between book and tax basis as would be required under Section 704(c)).

66 Goldberg, *supra* note 54, at 705 ("[C]apital accounts can get out of alignment if the partnership's accountants havemade allocations erroneously . . . so that even reversal allocations . . . fail to bring the partner's capital accounts into alignment with the economic deal. Under the Treasury Method, those errors can affect the economic arrangement of the partners.").

67 *See* Goldberg, *supra* note 54 at 728.

68 For the deficit restoration obligation, see Treas. Reg. § 1.704–1(b)(2)(ii)(b)(3).

69 *Id.*; *see also* Treas. Reg. § 1.704–1(b)(2)(ii)(h) (providing that DRO may be implied by the totality of the parties' economic arrangements, such as by an indemnification agreement, even if not explicitly stated).

70 REG–122855–15, 2016-52 I.R.B. 926 (Dec. 27, 2016) ("[S]ome partnerships are intended to have perpetual life and other partnerships can effectively cease operations but not actually liquidate; therefore, a partner's DRO may never be required to be satisfied.").

71 *See, e.g.*, Treas. Reg. § 1.701–2(d), Ex. (6) (DRO is part of a regulatory scheme that enables the taxpayers to realize "significant timing benefits through the special allocation" without being challenged based on the underlying economics of the proposed transaction).

partners to personally guarantee a partnership debt that entails little economic risk, such as the so-called bottom dollar guarantee.[72]

Under the current regulations, a DRO must be legally enforceable and there cannot be a plan to avoid or circumvent such an obligation.[73] In the 2016 proposed regulations, the Treasury added several factors to help test for whether an obligation is legally enforceable and whether there is a plan to avoid.[74] These factors included commercially reasonable provisions for enforcement and collection, commercially reasonable documentation regarding the partner's financial condition, whether the purported DRO can be terminated before being triggered, and whether its terms are provided to all partners in a timely manner.[75] The Treasury also expressed concern that a purported DRO may never be triggered and requested comments on this issue.[76] This indicates that the Treasury is starting to question the economic significance of many purported DROs and suggests that it may enforce the restriction in Treasury Regulation Section 1.704-1(b)(2)(ii)(c) more robustly in the future.

Even if a DRO is legally enforceable and there is no plan to avoid, its economic significance may still be questionable if the capital account deficit caused by an initial allocation is likely to be restored by subsequent allocations.[77] As a general rule, the economic effect of an allocation is not "substantial" and thus not respected for tax purposes if the partners' capital account balances would be the same without the allocation (because of anticipated offsetting allocations) but their overall tax liability is significantly reduced in present value terms.[78] However, since under current regulations a partnership property's value is presumed to be its adjusted basis when determining substantiality of economic effect (the so-called "value-equals-basis assumption"), an offsetting allocation based on the gain on sale of such property can never be anticipated.[79] As a result, a partner may be allocated a large depreciation deduction that results in a deep capital account deficit as long as she promises to restore it at liquidation, even if it is obvious that the property will likely preserve value (for example, if the property were the Empire State Building) and there is no real economic risk of loss. The *Orrisch* case may also have a different result under the value-equals-basis assumption. Administrative convenience may be one reason behind the value-equals-basis assumption.[80]

[72] *See* Treas. Reg. § 1.704–1(b)(2)(iii)(c)(2) ("[T]here cannot be a strong likelihood that the economic effect of an allocation (or allocations) will be largely offset by an allocation (or allocations) of gain or loss from the disposition of partnership property."); Treas. Reg. § 1.701–2(a)(3) (suggesting that the value-equals-basis assumption may have been adopted for administrative convenience or policy objectives other than matching tax with economics). *See also* Temp. Treas. Reg. § 1.752–2T (2016) (representing the Treasury's recent efforts to combat abuses such as bottom dollar guarantees).

[73] *See* Treas. Reg. § 1.704–1(b)(2)(ii)(c)(2).

[74] Prop. Treas. Reg. § 1.752-2(j)(3)(ii), REG-122855-15, 2016-52 I.R.B. 925-26 (Dec. 27, 2016).

[75] REG–122855–15, 2016-52 I.R.B. 925 (Dec. 27, 2016); *see also* Prop. Treas. Reg. § 1.704–1(b)(2)(ii)(c)(4)(B), 81 Fed. Reg. 69, 301, 69, 307 (2016).

[76] REG–122855–15, 2016-52 I.R.B. 926 (Dec. 27, 2016).

[77] *See* Treas. Reg. § 1.701–2(d), Ex. (6)(i) to (ii) (noting that the value-equals-basis assumption enables the partners to "anticipate significant timing benefits through the special allocation."). Assume, for example, a special allocation of depreciation deductions attributable to a building causes a capital account deficit. Such a deficit will have little ex-ante economic significance because the partners anticipate that the building will preserve value and the allocation is thus motivated solely by tax incentives, a problematic result explained further in Part II.C.

[78] *See* Treas. Reg. § 1.704–1(b)(2)(iii)(a)-(c).

[79] *See* Treas. Reg. § 1.704–1(b)(2)(iii)(c) (describing transitory allocations).

[80] *See* Treas. Reg. § 1.701–2(a)(3).

Another rationale, although not directly mentioned in the regulations, may be to encourage taxpayers to rely on the SEE safe harbor rather than the PIP test,[81] as the assumption is available only under the SEE safe harbor.[82]

An abuse similar to the DRO abuse explained above is possible through the personal assumption of partnership debt where such an assumption lacks real economic risk. Although the amount of tax deductions from partnership activities that a partner can take is limited to her outside basis,[83] a partner can personally guarantee partnership debt to increase the outside basis.[84] In 2014, the Treasury started to worry about the level of economic significance in some of these guarantees, as evidenced by its 2014 proposed regulations to ban abuses such as the use of bottom dollar guarantees where only "theoretical" risk is present.[85] The 2014 proposed regulations imposed a heavy compliance burden on partners who claimed to have personally assumed a partnership debt, including maintenance of a commercially reasonable net worth and contractual restrictions on asset transfers.[86] The Treasury eventually withdrew from such a broad and potentially expensive anti-abuse rule and currently only limits the scope of the ban to bottom dollar payment obligations.[87] To illustrate, a bottom dollar payment obligation would occur when a partner guarantees only the decline in value of the collateral in the bottom range, e.g., from $1M to zero for a $10M property.[88] However, practitioners have suggested that the new rule creates further inequality between economically identical transactions.[89]

Similar to the proposed changes to DRO regulations, the Treasury also proposed factors in 2016 that would help to determine when a plan seeks to circumvent or avoid an obligation through the personal assumption of partnership debt.[90] Although the 2014 proposed regulations have been withdrawn, the lesson is that the Treasury will pay more attention to the economic significance of payment obligations to a partnership, even though, as some practitioners suggest, the result may be a mere switch from one artificiality to another.[91] On one extreme, the *Tufts* case permits taxpayers to take nonrecourse deductions even if there is zero economic risk of loss and balance it with an artificial minimum gain.[92] This seems to be in tension with Treasury's more unfavorable treatment of the bottom dollar guarantee, which has significantly reduced economic risk (but not zero economic risk) as in the case of nonrecourse debt.

81 For PIP test, see *supra* note 39.

82 *See, e.g.*, Cavanagh, *supra* note 39 at 96 (stating that the regulations do not incorporate the value-equals-basis assumption in the PIP test).

83 *See* I.R.C. § 705(a)(2) (providing that partnership losses cannot reduce a partner's outside basis below zero).

84 *See* I.R.C. § 752(a) (providing that an increase in a partner's share of liabilities is treated as a contribution of money); Treas. Reg. § 1.752–2 (providing the rules governing a partner's share of recourse liabilities).

85 *See, e.g.*, Richard M. Lipton, *Proposed Regulations on Debt Allocations: Controversial, and Deservedly So*, 120J. TAX'N 156, 165-67 (2014) ("The Proposed 752 Regulations appear to be the product of obsessive concern about the fact that bottom-dollar guarantees can be used to allocate liabilities."); *see also* Prop. Treas. Reg. § 1.752–2(b)(3)(ii), 79 Fed. Reg. 4826, 4829-30 (2014).

86 *See* Prop. Treas. Reg. § 1.752–2(b)(3)(ii)(A), 79 Fed. Reg. 4826, 4836 (2014).

87 *See* REG–122855–15, 2016-52 I.R.B. 892-93 (Dec. 27, 2016); Temp. Treas. Reg. § 1.752–2T(a)(3)(ii).

88 For a definition of bottom dollar payment obligation, see Temp. Treas. Reg. § 1.752–2T(a)(3)(ii)(C).

89 *See* Lipton, *supra* note 85 at 167 (noting that the bottom dollar payment obligation ban can be circumvented by tranching debt).

90 *See* Treas. Reg. § 1.752–2(j) (describing instances where payment obligations may be disregarded).; Prop. Treas. Reg. § 1.752–2(j)(3)(ii), 81 Fed. Reg. 69,301, 69,308 (2016).

91 *See* Lipton, *supra* note 85 at 157 (suggesting that the 2014 proposed regulations under section 752 are just another set of artificial rules to deal with the artificiality in the *Crane* doctrine).

92 *See* Commissioner v. Tufts, 461 U.S. 300, 307-310 (1983).

C. Economic Effect Equivalence: Solution to One Size Fits All?

As discussed in Part III.B., the Treasury's capital account approach and anti-abuse efforts under Subchapter K may not fully eliminate the mismatch between tax and economics and may lead to artificial results. However, an allocation may be deemed to have economic effect under the economic effect equivalence test (the "EEE test"), a less used alternative available under the SEE safe harbor. The EEE test supplies flexibility but also adds uncertainty to the SEE safe harbor. It determines economic effect based not on actual use of capital accounts, but rather on whether the hypothetical liquidation results under the partners' own arrangement match the results that would have been reached had capital accounts been properly maintained and used. The EEE test thus seems to focus on achieving a good end-result rather than on the means to achieve such result. Since the Treasury has included very little guidance on how to apply the test, there are arguments both for reading it broadly and narrowly.[93] This Part III.C. will examine the current interpretations of the EEE test and argue that it should be interpreted in a way that is sufficient to safe harbor the most non-abusive allocations that do not follow the Treasury's capital account method.

1. The Four-Part Analysis for Economic Effect Equivalence

The EEE test will be satisfied if a liquidation of the partnership at the end of the current or any future year would produce the same economic results as would occur if the primary test is satisfied, "regardless of the economic performance of the partnership."[94] Under the regulations, the EEE test seems to be a four-part analysis. First, one must determine each partner's economic entitlement to the partnership's net assets under the partnership agreement in a current or future liquidation, i.e., how partners intend to share the benefit or burden of whatever remains after all partnership assets are sold and the proceeds are used to pay the partnership's creditors. Second, one must determine the partners' explicit or implied allocation of partnership income, gain, loss, deduction, or credit under the partnership agreement. Third, based on such explicit or implied allocation, one must determine or re-calculate the capital account balances as if capital accounts had been properly maintained under the primary test. Fourth, assuming that a liquidating distribution will be made according to such capital account balances and that each partner has an unlimited DRO, one must determine whether each partner's economic entitlement in a current or future liquidation would be the same as that under the partnership agreement, "regardless of the economic performance of the partnership."

93 *See, e.g.*, Goldberg, *supra* note 54 at 728-29 (suggesting that the EEE test should be clarified or expanded to explicitly safe harbor allocations not based on capital accounts such as the target method of allocation); I.R.S., MARKET SEGMENT SPECIALIZATION PROGRAM GUIDELINE, PARTNERSHIPS, 2002 WL 32770029 117 (2002) (noting that the EEE Test is a "dumb-but-lucky" rule intended to protect allocations based on "unsophisticated but unabusive partnership agreements").

94 The regulations define economic effect equivalence as follows: allocations made to a partner that do not otherwise have economic effect under this paragraph (b)(2)(ii) shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if requirements (1), (2), and (3) of paragraph (b)(2)(ii)(b) of this section had been satisfied, regardless of the economic performance of the partnership. Treas. Reg.§1.704–1(b)(2)(ii)(i).

Consider the following two examples provided in the regulations on the EEE test, which seem to support the four-part analysis mentioned above.[95]

Example Two

G and H contribute $75,000 and $25,000, respectively, to form a general partnership. The partnership maintains no capital accounts (thus does not satisfy the primary test) and the partnership agreement provides that all income, gain, loss, deduction, and credit will be allocated 75 percent to G and 25 percent to H. In addition, G and H are ultimately liable (under a State law right of contribution) for 75 percent and 25 percent, respectively, of any debts of the partnership. In other words, the state law right of contribution has the same effect as an unlimited DRO. Neither partner has any DRO. The regulations state that, under these circumstances, the allocation of all partnership items in 75/25 ratio has economic effect equivalence.[96]

The rationale is an implied four-part analysis. First, the partnership agreement, combined with the State law right of contribution, essentially provides that G and H will share partnership net assets 75/25 in a liquidation, equal to the ratio of their original capital contributions. Second, the partnership agreement explicitly provides for an allocation of all partnership items 75/25 to G and H, respectively. Third and fourth, at the time of a current or future liquidation, G's and H's economic entitlements would be the same as if they started with capital account balances of $75,000 and $25,000, respectively, and such balances are increased by partnership income or gain and decreased by partnership loss, deduction, or credit in a 75/25 ratio of such items, respectively.[97] If such balances are positive at liquidation and, assuming liquidating distributions are made according to capital account balances, G and H will certainly receive partnership net assets in a 75/25 ratio, the same result as under the partnership agreement.[98] If such balances are negative at such time and, since the state law right of contribution has the same effect as an unlimited DRO, each partner has satisfied partnership liabilities to the extent of partnership assets in a 75/25 ratio, using their respective shares of partnership assets, and is obligated to satisfy the remaining liabilities in a 75/25 ratio under the unlimited DRO. This result is the same as that under the partnership agreement. Thus, regardless of the partnership's economic performance, i.e., regardless of how well that partnership's business goes, the allocation of all partnership items in a 75/25 ratio produces the same economic result as if the primary test has always been satisfied, and it must have economic effect equivalence under the regulations.

Example Three

G and H contribute $75,000 and $25,000, respectively, to form a general partnership. The partnership agreement provides that all partnership items will be allocated equally between the partners, and that capital accounts will be maintained as required by the primary test, but that all partnership distributions will be made 75 percent to G and 25 percent to H regardless of capital account balances. However, all partners have an unlimited DRO.[99] The regulations state that the allocation of all partnership items equally to G and H has economic

[95] *See* Treas. Reg. § 1.704–1(b)(5), Ex. (4)(i) - (iii).
[96] Treas. Reg. § 1.704–1(b)(5), Ex. (4)(ii).
[97] For rules governing the maintenance of capital accounts, *see generally* Treas. Reg. § 1.704–1(b)(2)(iv).
[98] This is based on the simple mathematical truth that (75,000 + 0.75 * X)/(25,000 + 0.25X), where X is any rational number, except the value of negative 100,000 to prevent division by zero, is always equal to 75/25.
[99] *See* Treas. Reg. § 1.704-1(b)(5), Ex. (4)(iii).

effect equivalence, even if the partnership agreement doesn't require a liquidating distribution to be made according to capital account balances.

The rationale, similar to that in Example Two, is an implied four-part analysis. First, G and H's economic arrangement under the partnership agreement is to recover invested capital (if possible) and to share any change in partnership net assets equally in liquidation.[100] Second, the partnership agreement explicitly provides equal sharing of all partnership items. Third, let X be the change in partnership net assets (without regard to any withdrawal or distribution) from the time of partnership formation to the time of liquidation. The capital account balances calculated in accordance with the regulations are (75,000 + 0.5X) for G and (25,000 + 0.5X) for H. Fourth, assuming liquidating distributions are made according to capital account balances and there is an unlimited DRO for each partner, G will receive (or is obligated to contribute) (75,000 + 0.5X), while H will receive (or is obligated to contribute) (25,000 + 0.5X), which is the same as the result under the partnership agreement,[101] regardless of the partnership's economic performance, i.e., regardless of the value of X. Thus, the allocation of all partnership items equally between G and H must have economic effect equivalence.

2. *"Regardless of the Economic Performance of the Partnership" — What Does It Mean?*

A threshold question in the application of the EEE test is how broadly to interpret the phrase "regardless of the economic performance of the partnership."[102] There are three possible interpretations, varying based on which economic activities and which outcomes of economic activities are considered when determining the results of a hypothetical liquidation.

First, a strict interpretation would interpret the words "economic performance" in the broadest sense and assume that it covers all logically possible economic results of the partnership. This interpretation would require the liquidation result under the partnership agreement to match the result under the primary test regardless of the economic activities that the partnership can possibly engage in and the outcome of such activities. For example, assume A and B each contribute $50X cash to form Partnership AB and agree that all partnership items will be allocated 50/50. There is no unlimited DRO. Under the strict interpretation, the EEE test is not satisfied because, among other reasons, it is possible that the partnership leverages

100 If this is not obvious, let X be the change in partnership net assets (without regard to any withdrawal or distribution) from the time of partnership formation to the time of liquidation. The capital account balances under the partnership agreement are (75,000 + 0.5X) for G and (25,000 + 0.5X) for H. However, since distribution will be made to G and H in a 75/25 ratio, respectively, G will receive (75,000 + 0.75X) from the partnership distribution, while H will receive (25,000 + 0.25X). Since capital account balances are properly maintained as required by the primary test, G will end up with a deficit of 0.25X, while H will have an unpaid balance of 0.25X, after liquidation. Since each partner has an unlimited DRO, G is obligated to make an additional contribution of 0.25X to the partnership, which will be distributed to H. When the dust has settled, G's liquidation entitlement is (75,000 + 0.5X) and H's entitlement is (25,000 + 0.5X).

101 *Id.*

102 *See, e.g.*, NYSBA TAX SECTION, REPORT ON PARTNERSHIP TARGET ALLOCATIONS3, 27-28 (Report No. 1219, 2010) (noting that it is uncertain whether the phrase "regardless of economic performance" is intended to encompass all facts and circumstances, and advocating that it be clarified to encompass only facts and circumstances reasonably likely to occur).

up in the future. If the partnership later borrows $900X to acquire a property worth $1,000X and the property loses all its value, A and B will each have a capital account deficit of $450X, but there is no obligation to restore the deficit. Under the strict interpretation, the fact that the partnership does not currently have any debt and does not expect to incur any in the future is irrelevant.

Second, an intermediate interpretation would require the two results to match regardless of the outcomes of the economic activities the partnership is currently undertaking or reasonably expects to undertake in the future, but all possible outcomes of each such activity must be considered unless the partnership agreement itself contains certain provisions that tend to eliminate some of those outcomes. The intermediate interpretation seems to be in line with the NYSBA's position in its 2010 report.[103] Under the intermediate interpretation, the expectation not to incur any debt is taken into account if reasonable, but the expectation that capital account deficits will not be an issue because the business will be profitable is not taken into account.

Third, a liberal interpretation would require the two results to match regardless of the reasonably expected outcomes of current or reasonably expected future economic activities. In other words, unlike the strict interpretation, this interpretation would not require the results to match under all economic activities that the partnership may engage in, but only those that they reasonably expect to have. Additionally, unlike the intermediate interpretation, this interpretation gives deference to the partners' reasonable expectations of the outcomes in comparing hypothetical liquidation results. For example, the expectation that capital account deficits will not be an issue because the business will be profitable can be respected under the liberal interpretation but is always rejected under the intermediate interpretation.

Since the two examples in the regulations seem to satisfy the EEE test even under the strict interpretation, those examples provide little guidance on how the Treasury intends to interpret the EEE test.[104] As a result, it is uncertain how the Service will react to an allocation that satisfies the EEE test only under the intermediate or the liberal interpretation. For example, if an allocation satisfies the EEE test only under the assumption that the partnership is not reasonably expected to have leveraged transactions or to acquire depreciable properties in the future, or that its properties are reasonably expected to preserve value, it's uncertain whether the EEE test can give economic effect to such allocation under the current law.[105]

From a policy perspective, the strict interpretation should be rejected for two reasons. First, the purpose of the SEE safe harbor is to prevent partnership-related activities done solely or primarily for tax purposes, in which the partners expect an increase in after-tax payoff without simultaneously expecting an increase in pre-tax payoff.[106] Such transactions have the same efficiency problems as explained in Part II.[107] In an ideal world where a person's actual

[103] *Id* at 3(4) (suggesting that the EEE test should require reaching the result under the primary test only in all fact patterns reasonably likely to occur).

[104] *See* discussions in Part III.C.1., *supra*. In Example Two, even if the partners end up with a capital account deficit due to leveraged transactions, the State law right of contribution ensures the same liquidation result as that would occur if the partners had an unlimited DRO and the primary test had been satisfied. In Example Three, the unlimited DRO ensures the same liquidation result as would occur under the primary test, even if the partnership engages in leveraged transactions or acquires depreciable properties.

[105] *See* NYSBA TAX SECTION, *supra* note 102, at 27-28.

[106] *See* Treas. Reg. § 1.704–1(b)(2)(ii)(a) (stating the "fundamental principle" that an allocation must comport with the economic deal among the partners in order to have economic effect).

[107] Part II, *supra*.

expectations can be ascertained precisely at the regulatory level, the parties' *ex ante* expectations, rather than the *ex post* outcome, should govern a transaction from an efficiency perspective. Therefore, to maximize efficiency, if the partners do not reasonably expect to undertake certain economic activities that may cause an allocation to fail the EEE test, the allocation should not be disregarded merely because a technical failure of the EEE test may be a logical *ex post* outcome. Second, since in theory all partnerships may engage in unlimited recourse borrowing or other transactions which may cause a capital account deficit under certain conditions, such as in a "doomsday" scenario, the strict interpretation essentially requires all partners to have an unlimited DRO under a partnership agreement or under state law in order to satisfy the EEE test.[108] This may bring the EEE test too close to the primary test and reduces its usefulness in giving economic effect to allocations that do not follow the Treasury's capital account approach but are nonetheless harmless.[109]

The liberal interpretation should also be rejected because it requires too much fact-finding and causes too much uncertainty and therefore diminishes the utility of the EEE as a safe harbor. Consider the following example.

Example Four

A and B each contribute $500X to form a general partnership, and the partnership acquires a depreciable building for $1,000X to be rented out. The partnership agreement provides that all partnership items are shared equally except that all depreciation will be allocated to A, but there is no DRO requirement and no provisions that tend to restrict capital account deficits in the agreement. The partners claim that they reasonably expect A's share of future rent to fully offset his share of partnership expenses including depreciation, and leasing the building will be the only partnership activity. Based on this, they argue that a capital account deficit is unlikely and thus the allocation satisfies the EEE Test. In this case, the liberal interpretation will not only welcome *ex post* justifications, but also require determination on difficult factual questions such as the fair rental value of the building and the likelihood of a future property tax increase. It would also unduly enlarge the scope and uncertainty of the EEE Test, which was originally intended only as a limited exception for unsophisticated taxpayers.[110] If the partners are sophisticated enough to predict the success of their business, they should have no problem complying with the primary test or including provisions that tend to prevent capital account deficits.

Thus, the best interpretation of the phrase "regardless of the economic performance of the partnership" in the EEE Test seems to be the intermediate interpretation. Specifically, the EEE Test should be applied only based on the type of current and reasonably expected future

108 For the so-called "doomsday" test, see Treas. Reg. § 1.752-2(b).

109 Note that the alternate test does not require an unlimited DRO, but only that an allocation does not create or increase a deficit in excess of any DRO and a QIO provision in a partnership agreement. Treas. Reg. §1.704–1(b)(2)(ii)(d). However, the so-called "Safe Harbor Result" that the EEE test requires is the result under the primary test. *See* Treas. Reg. §1.704–1(b)(2)(ii)(i). *See also* NYSBA Tax Section, *supra* note 102, at 31 ("If an agreement contains a DRO, target allocations will necessarily take account of the DRO and will necessarily produce the Safe Harbor Result required under the EEE Test…"); *See also* Cavanagh, *supra* note 39,at 95-96 (believing that reading the EEE test as having an implied unlimited DRO requirement is too narrow; in addition, unlimited DRO in state law partnerships is rare today).

110 *See* I.R.S., *supra* note 93.

activities of the partnership, but for each such activity, one should consider all possible economic outcomes unless certain provisions in the partnership agreement tend to eliminate some of those outcomes. The intermediate interpretation also best reflects the policy behind the EEE test, which seems to be balancing the goal of matching tax consequences with economic realities with the need to avoid disturbing an efficient business arrangement for failure to comply with the Treasury's technical rules.

3. DRO Requirement and the EEE Test

A rejection of the strict interpretation leads to an interesting inquiry: when, if ever, an unlimited DRO under a partnership agreement or state law is required for an allocation to satisfy the EEE test. One may argue that an unlimited DRO throughout the term of the partnership is always required to satisfy the EEE test, on the ground that without such unlimited DRO, there is always a possibility that the partners can modify their agreement in the year of actual liquidation to provide for a liquidating distribution that fails to reflect their prior share of partnership items.[111] Consider the following example.

Example Five

Assume the same facts in Example Two, except that the partnership, a calendar year taxpayer, acquires depreciable equipment with a 10-year useful life (assuming that straight-line method is used) and no salvage value for $100,000X on 01/01/20X1. The partnership breaks even each year from the operation of the equipment, which is its sole activity, without considering depreciation, which is its only noncash expense. After 5 years, the partnership's balance sheet may look as follows:

Partnership's Book		Safe Harbor Capital Account	
Asset		Asset	
Equipment	$50,000X	Equipment	$50,000X
Capital		Capital	
G's Capital	37,500X	G's Capital	37,500X
H's Capital	12,500X	H's Capital	12,500X

On 12/31/20X5, the partners modify their agreement to provide that all liquidating distributions will be made to G. The partnership then sells the equipment for $50,000X (its presumed fair market value), distributes all $50,000X cash to G, and liquidates. Immediately after liquidation, the partnership's balance sheet is as follows:

Partnership's Book		Safe Harbor Capital Account	
Capital		Capital	
G's Capital	($12,500)X	G's Capital	($12,500)X
H's Capital	12,500X	H's Capital	12,500X

Here, the liquidation result under the partnership agreement and that under the safe harbor capital account will differ. Under the partnership agreement, because there is no DRO,

111 For modification of a partnership agreement, see I.R.C. § 761(c).

G has been allocated a net loss of $37,500X for tax purposes but only economically assumes $25,000X of such loss, with the additional $12,500X loss assumed by H. Under the safe harbor capital account, because each partner is assumed to have an unlimited DRO, G is obligated to contribute $12,500X to the partnership to be distributed to H. Thus, the 75/25 allocation as described in Example Two will technically fail the EEE test from the very beginning because of the possibility that the scenario above may occur (call it a "liquidation surprise"). Note that logically, the possibility of a liquidation surprise cannot be explained away by a "reasonable expectation" of not to have a liquidation surprise. Since the decision is almost purely subjective, such an expectation cannot be "reasonable."

The problem of a liquidation surprise can theoretically happen under the EEE test because the EEE test requires an allocation to generate the same liquidation result as that under the primary test in a *hypothetical* liquidation, and justifies an allocation based on a matching of *hypothetical* liquidation results. Consequently, unless an allocation is deemed to fail the EEE test from the very beginning because of the possibility of a liquidation surprise, the EEE test cannot stop the abuse. By the time the liquidation surprise occurs in an *actual* liquidation, allocation of partnership items is no longer an issue and all prior allocations have already satisfied the EEE test through a matching of *hypothetical* liquidation results.[112] This problem is also connected to the "ceiling rule" issue (discussed in Part III.B.1 and will be further discussed in Part IV), as the section 704 regulations usually disallow the creation and allocation of fictitious partnership-level gain or loss to adjust capital account balances and cause them to match the actual liquidation result;[113] otherwise, maintenance of a capital account will be reduced to little more than an accounting routine.

Of course, the liquidation surprise is more of a theoretical possibility than an actual abuse. Theoretically, without an unlimited DRO "throughout the full term of the partnership,"[114] an allocation that satisfies the EEE test can never be economically equivalent *ex ante* to an allocation that satisfies the primary test, regardless of whether a capital account deficit can be "reasonably expected," because the possibility of a liquidation surprise cannot be explained away (as is the case in Example Five). A practical question to ask, therefore, is whether and to what extent a DRO should be required in order to satisfy the EEE test. A corollary question is, without an unlimited DRO, what the IRS should do in the case of an unexpected capital account deficit if a prior allocation has been treated as satisfying the EEE test.

Practitioners' views on the DRO requirement in the EEE test diverge. Some, like Cuff, believe that a partnership agreement may need an explicit unlimited DRO provision or an implied unlimited DRO under state law in order to satisfy the EEE test, but also think that "this matter is not unambiguously clear from the Allocation Regulations."[115] He also believes that broad application of the EEE test to LLCs, for which an unlimited DRO is rare, should be

[112] By contrast, a liquidation surprise cannot happen under the primary test because, to be able to invoke the primary test of the SEE safe harbor at all, the partnership agreement must provide liquidating distributions in accordance with capital account balances and unlimited DROs "throughout the full term of the partnership." *See* Treas. Reg. §. 1.704-1(b)(2)(ii)(b).

[113] *See supra* note 52. *See also infra* Part IV.A.

[114] *See supra* note 112.

[115] *See* Terence Floyd Cuff, *Several Thoughts on Drafting Target Allocation Provisions*, 87 Taxes 171, 188 (Mar. 2009).

rejected.[116] Given the precision with which the DRO requirement is written in the regulations and its arguable importance, he believes that the Treasury did not intend it to be easily circumvented through the EEE test, which is only a limited exception to the extensive and precise economic effect of safe harbors.[117] However, Cuff suggests that the EEE test should be applied more flexibly to accommodate the prevalence of LLCs, especially when the lack of DRO is not abusive.[118]

Others, like Cavanagh and the NYSBA Tax Section in its 2010 report, propose a more liberal interpretation of the EEE test and believe that, although the current law in this area is unclear, an unlimited DRO should not always be required for an allocation to satisfy the EEE test, especially when the partnership agreement explicitly prohibits transactions that may cause a capital account deficit or contains a QIO provision.[119] To reduce regulatory uncertainty, Cavanagh recommends that the Service describe circumstances under which the EEE test applies to a partnership without an unlimited DRO in a notice or revenue ruling; this includes circumstances under which "the partners do not or cannot have a capital account deficit."[120] In addition, Cavanagh believes that it "would not be a wise use of IRS resources" to require an unlimited DRO for the EEE test at all times, which is supposed to serve as "a safety net for unsophisticated taxpayers and their advisers."[121] An opposite rule would deprive many taxpayers (such as members of an LLC) of the benefit of the safe harbor and would force them to rely on the PIP test,[122] which is more burdensome because of the lack of taxpayer-favored assumptions such as value-equals-basis assumption.[123] The lack of the value-equals-basis assumption in the PIP test may put the burden on the partners to show both the current and future value of partnership properties, which can be expensive and burdensome.

The NYSBA Tax Section makes a similar suggestion in its 2010 report: a partnership agreement without an unlimited DRO should satisfy the EEE test if a capital account deficit is only a "remote possibility" under the agreement.[124] This potentially includes an agreement that prohibits aggregate negative adjustments to a partner's capital account to exceed aggregate positive adjustments.[125] In addition, the report suggests that the possibility that an allocation may cause a capital account deficit, but not in excess of a partner's share of partnership minimum gain, should be disregarded for purposes of the EEE test, just as such amount is treated as a limited DRO for purposes of the alternate test,[126] because such deficit will be reversed when partnership minimum gain is realized.[127]

116 *Id.* at 191.
117 *Id.*
118 *Id.* at 189.
119 *See* NYSBA Tax Section, *supra* note 102, at 28-31; Cavanagh, *supra* note 39, at 89 (advocating that the IRS confirm that the EEE test applies to a partnership agreement that has a QIO provision).
120 Cavanagh, *supra* note 39, at 96. Currently, the only guidance provided in the regulations on the DRO requirement in the EEE test is that a partnership without an unlimited DRO may satisfy the EEE test if, under the respective state law right of contribution, each partner must "contribute any debts of the partnership in proportion to their shares of partnership profits." *See* Treas. Reg.§1.704-1(b)(5), Ex. (4)(ii); NYSBA Tax Section, *supra* note 102, at 28 n.60.
121 Cavanagh, *supra* note 36, at 95-96.
122 *Id.* at 96.
123 *See supra* note 82.
124 NYSBA Tax Section, *supra* note 102, at 28.
125 *Id.* at 29.
126 *Id*. *See also* Treas. Reg. § 1.704-2(h)(4), (i)(5) (for purposes of the alternate test, a partner's share of minimum gain is treated as a limited DRO).
127 *See* Treas. Reg. § 1.704-2(f).

Similar to the rationale of rejecting the strict interpretation of the "regardless of the economic performance of the partnership" language in the EEE test, an unlimited DRO should not be a mandatory element of the test. Specifically, the Service should take a position that if a capital account deficit is only a remote possibility after taking into account (1) the type (but not the expected outcomes) of economic activities that the partners currently undertake or reasonably expect to undertake in the future, (2) the tax attributes of the partnership (such as partnership minimum gain) as well as (3) the partners' agreement such as liquidation entitlement and any arrangement that tends to prevent a capital account deficit, while ignoring the theoretical possibility of a liquidation surprise, unlimited DRO should not be required for an allocation to satisfy the EEE test.[128] The EEE test, as a "dumb-but-lucky" rule intended to protect "unsophisticated but unabusive partnership agreements,"[129] should not be so inflexible as to require unlimited DRO even when its absence is totally "unabusive."

4. *Nonrecourse Deductions and the EEE Test*

It is noteworthy that under current regulations, the PIP test (including its safe harbor version) is the only test available for the partnership nonrecourse deductions (such as depreciation on properties financed by allocation of nonrecourse debt), which are correctly treated by the regulations as never having economic effect, unless a safe harbor test applies.[130] Since the PIP test is less technical and more fact-driven, whether the Service will respect an allocation of nonrecourse deductions under the PIP test is hard to know.[131] For example, the Service may logically require an allocation of nonrecourse deductions to be made strictly in accordance with the partners' relative contributions when the realization of partnership minimum gain through taxable disposition of partnership properties is remote. The PIP version of safe harbor test for allocation of nonrecourse deductions is also stricter than the SEE safe harbor: the allocation must either satisfy the primary test, or, if it fails the primary test because an unlimited DRO is lacking, the partnership agreement must have a QIO provision.[132] The test also requires nonrecourse deductions to be allocated "in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities."[133] For example, if income and expense attributable to the property securing the nonrecourse liability

[128] For example, if the only reasonably expected activity of a partnership is to hold equity securities, the partnership will incur no debt, and a liquidating distribution will be made strictly in proportion to capital contributions, an allocation of all partnership items in proportion to capital contributions is very unlikely to cause a capital account deficit, based on the type of economic activities and the partners' liquidation arrangement. Thus, an unlimited DRO should not be required for applying the EEE test. By contrast, if the same partnership takes out recourse debt and invests the proceeds in equity securities, an unlimited DRO may be required for applying the EEE test regardless of how small the downside risk of the equity securities is perceived to be, because the speculative outcome of an economic activity should not justify a lack of an unlimited DRO for purposes of the EEE test.

[129] I.R.S., *supra* note 93.

[130] *See* Treas. Reg. § 1.704-2(b)(1).

[131] See Treas. Reg. § 1.704-2(e) for when allocations of non-recourse deductions will satisfy the PIP test.

[132] Treas. Reg. § 1.704-2(e)(1).

[133] Treas. Reg. § 1.704-2(e)(2). An example would be income generated by the property securing the nonrecourse liability. *See also* discussion in Part II.D., *supra*.

will be allocated 50/50 between the partners and, assuming that the allocation satisfies the SEE safe harbor, allocations of nonrecourse deduction ranging from 50/50 to 90/10 may be considered reasonable, but there is no bright-line rule on this issue.[134]

An implication of the wording of the nonrecourse deduction regulations is that, if the partnership agreement does not include provisions that satisfy either the primary or the alternate test, it is not entitled to a safe harbor for allocation of nonrecourse deductions, and satisfying the EEE test cannot save the day. This is because instead of referring to the SEE safe harbor generally, the nonrecourse deduction regulations specifically require certain elements in the primary test and the alternate test to be satisfied in order for the safe harbor to apply.[135]

One may argue that as a matter of tax policy, if allocations under a partnership agreement satisfy the EEE test overall, the nonrecourse deduction safe harbor should apply to allocations of nonrecourse deductions under the partnership agreement.[136] There are two rationales behind this argument. First, an allocation of nonrecourse deductions by itself always has economic effect equivalence due to the artificial rule of minimum gain chargebacks. Regardless of how remote the chargeback is, an allocation of nonrecourse deduction will almost never cause a deviation of the outcome in a current or future hypothetical liquidation from that mandated by the primary test since its net effect on capital account balances is zero, and thus will always satisfy the EEE test. Second, if all other material allocations under the partnership agreement also have economic effect equivalence, the substance of the partnership agreement would be as if it contains provisions that satisfy the primary test, and the form of the deal, i.e., the specific wording of the partnership agreement, should not make a substantive difference. Consider the following example.

Example Six

Assume the same facts as in Example Two, except that G and H also take out a $100,000 nonrecourse debt, acquire depreciable property for $100,000 and use the property to secure the debt. G and H allocate depreciation deductions from the property in a ratio of 75/25. The allocation does not affect the analysis under the EEE test and is obviously non-abusive. However, under current law, the allocation is not safe harbored since the partnership agreement does not directly satisfy the primary or the alternate test.

5. *When "Reasonable" Expectation Fails*

Whether the meaning of the words "regardless of the economic performance of the partnership" should be required and whether unlimited DRO should be required both depends, to some extent, on the partners' reasonable expectations.[137] Two questions therefore arise: first, what kind of deference the Service should give to the partners' statement of their own business

[134] *See, e.g.*, Treas. Reg § 1.704-2(m), Ex. 1(ii).
[135] Treas. Reg. § 1.704-2(e).
[136] *See* Cuff, *supra* note 115, at 180 (arguing that a target allocation provision may satisfy the nonrecourse deduction safe harbor if allocations thereunder have economic effect under the EEE test, but indicating that "whether this argument works is a matter of conjecture"); Todd D. Golub, *Target Allocations: The Swiss Army Knife of Drafting (Good for Most Situations—But Don't Bet Your Life on It)*, 87 Taxes 157, 163-64 (Mar. 2009) (arguing that if allocations satisfy the EEE test, such as in a target allocation scenario, strict compliance with this aspect of the nonrecourse deduction safe harbor really shouldn't be necessary as the allocations would be deemed to have economic effect).
[137] *See* discussions in Part III.C.2 and Part III.C.3, *supra*.

plan and expectations; second, what the Service should do if an expectation determined to be "reasonable" *ex ante* deviates from the *ex post* outcome.

This Note argues that to reduce administrative cost and to initially respect the parties' self-claimed business arrangement, the Service should first defer to the partners' articulated expectations on the partnership business, unless the partners' position is obviously unreasonable. This initial deference can help avoid disturbing an otherwise efficient business plan by the Service's own judgment, especially when a purported allocation is likely to be unabusive. However, under a "wait-and-see" rule, if it is later determined that the original expectation did not materialize and the this is reasonably expected to continue in the future, the Service may determine that the original expectation becomes unreasonable starting from the time of the determination, until the non-conformity discontinues and future conformity is reasonably expected again.[138] Under a "tit-for-tat" rule, the Service may determine that, in hindsight, the original expectation is not reasonable from the beginning, and may require a re-calculation of the partners' taxes in all prior years to which the allocation is relevant. Consider the following example.

Example Seven

A and B each contributes $50X to form Partnership AB. The partnership borrows $900X on a recourse basis to buy depreciable equipment with a 20-year useful life for $1,000X. The partnership agreement provides that all partnership items will be allocated 50/50 except that depreciation will be allocated 70/30 to A and B. In addition, capital accounts will be maintained according to the relevant regulations and liquidating distributions will be made according to positive capital account balances, but the partners do not have unlimited DROs and the partnership agreement does not have a QIO provision. However, the partnership agreement requires reallocation of partnership items whenever possible to prevent aggregate negative adjustments to a partner's capital account from exceeding aggregate positive adjustments. The partnership breaks even in the first three years except for the depreciation, and no payment of principle is made. The balance sheet is as follows.

Partnership AB's Book					
Year 1		Year 2		Year 3	
Asset		Asset		Asset	
Equipment	$950X	Equipment	$900X	Equipment	$850X
Liability		Liability		Liability	
Recourse Debt	900X	Recourse Debt	900X	Recourse Debt	$900X
Capital		Capital		Capital	
A's Capital	15X	A's Capital	0	A's Capital	(35X)
B's Capital	35X	B's Capital	0	B's Capital	(15X)

In this case, the Service should initially assume that the partners' arrangement will be given effect throughout the term of the partnership and that the partnership business is reasonably expected to be profitable eventually. Based on these assumptions, it may conclude that a capital account deficit is a remote possibility. Thus, the allocation of depreciation

[138] *See* NYSBA Tax Section, *supra* note102, at 28.

between A and B should be respected at least for the first year and the second year under the EEE test. Indeed, a reallocation of the $50X depreciation 50/50 between A and B for the first year is meaningless because the 70/30 allocation is unabusive: a liquidation at book value at the end of Year 1 under the partnership agreement will cause A and B to assume the total economic burden of depreciation 70/30. Similarly, the allocation of depreciation in Year 2 is unabusive because liquidating distributions at the end of Year 2 will match each partner's economic entitlement.

However, in Year 3, the original expectation that a capital account deficit is a "remote possibility" no longer seems to comply with what actually happens, because all partners will have capital account deficits, and the deficit-prevention rule in the partnership agreement can no longer prevent capital account deficits in Year 3 as it does in Year 2. Thus, the 70/30 allocation of depreciation in Year 3 can be abusive: in a liquidation at book value, suppose Partnership AB's creditors seek satisfaction of the remaining debt ($50X) entirely from B, and A, having no DRO under the partnership agreement, is not obligated to compensate B for personally assuming the partnership debt. Consequently, A is allocated $35X depreciation for tax purposes but does not assume an economic burden. However, under a "wait-and-see" rule, the Service may impose an additional burden on the partners to show that the business will eventually become profitable and may re-allocate the Year 3 depreciation under the PIP test. In addition, under a "tit-for-tat" rule, if the Service determines that the partners never reasonably expected to operate a profitable business through Partnership AB, it can determine in Year 3 that the original expectation that a capital account deficit is a remote possibility and was unreasonable from the beginning of Year 1 and make retroactive adjustments on the partners' tax liabilities in Year 1 and 2.

IV. TARGET ALLOCATION: A BETTER ALTERNATIVE?

There has been considerable discussion on whether the target method of allocation, where only the economic target at liquidation is specified and allocations of partnership items for tax purposes simply follow the economic target,[139] is superior to the Treasury's capital account method and thus should be adopted.[140] This Note argues that on one hand, the target allocation method can solve some of the mismatches between tax and economics as mentioned in Part III.B; but on the other hand, target allocation is in tension with the implied "ceiling rule" under section 704 regulations and can be used abusively. Consider the following example.

Example Eight

Assuming the same facts in Example One, except that, instead of complying with the Treasury's capital account method, the partnership agreement simply provides that A, B and C will be entitled to partnership net assets 50/25/25 in a liquidation, and any partnership item must be allocated in line with the economic target at liquidation. As a result, all gain from the sale of the remaining partnership properties immediately after distribution of Whiteacre to B will be allocated 50/25/25 to A, B and C, which will cause tax consequences to match the parties' economic arrangement. Under the Treasury's capital account method, however, as

[139] For general discussions of target allocations, see, e.g., Goldberg, *supra* note 54 at 668-87; Golub, *supra* note 136 at 161-70.

[140] *See, e.g.*, Goldberg, *supra* note 54at 700-714.

explained in Part III.B.2., the tax will mismatch the economics without a revaluation of all partnership properties at the time of distribution.

The use of target allocation in Example Eight is non-abusive and better reflects the parties' economic arrangement. However, it can in theory be used abusively as a means to circumvent the implied "ceiling rule" under section 704 regulations, which will be explained further in Part IV.A. and Part IV.B. Consider the example below.

Example Nine

A and B each contribute $50X to form Partnership AB. They intend from the very beginning to share partnership net assets 50/50 at liquidation. However, because they want to allocate more income to A for tax purposes due to A's favorable tax attributes (such as an expiring NOL), they specify that liquidation will be made 90/10 between A and B and partnership items will be allocated accordingly. After several years, when the value of partnership net asset is $200X and equal to the book value,[141] A and B modify their agreement to specify a liquidating distribution of 50/50 and immediately liquidate the partnership thereafter. In this situation, the target method essentially requires an allocation of $40X fictitious loss to A and a $40X fictitious gain to B in order for tax to comply with the liquidation target. This, however, is a violation of the implied "ceiling rule" and the target method is being used abusively for income shifting purposes. Although the abuse in Example Nine is unlikely to happen between parties in arm's length positions, it does reveal a tension between the target method and some of the fundamental principles under the section 704 regulations.

A. Capital Shifting and Tax Avoidance Motive

An important implication of the primary test under the SEE safe harbor is that capital shifting among partners, which is a mere re-allocation of capital account balances among partners without recognition of actual gain or loss at the partnership level and allocation of such gain or loss among partners, is prohibited. First, as mentioned earlier, the capital account maintenance rules under Treas. Reg.§1.704-1(b)(2)(iv) contain an implied "ceiling rule": the rules do not permit recognition of fictitious gain or loss at the partnership level solely for purposes of readjusting the partners' capital account balances.[142] Second, the unlimited DRO requirement under the primary test prohibits capital shifting through liquidating distributions. For example, if A and B each contributes $100X to form Partnership AB and the partnership is immediately liquidated, under the primary test, each partner must receive $100X. It's not possible for A to shift her $100X contributed capital to B by having the partnership recognize a fictitious gain of $100X entirely allocated to B and a fictitious loss of the same amount entirely allocated to A. Also, A cannot shift her contributed capital to B through a liquidating distribution of $200X entirely to B, because B will have a deficit of $100X and must pay A $100X due to the unlimited DRO.

141 To achieve this, A and B can sell all partnership properties for cash before modifying the partnership agreement.

142 From a policy perspective, the "ceiling rule" is necessary to prevent tax abuses where a partner is allocated partnership deductions or losses (actual or fictitious) leading to a capital account deficit and is later allocated a fictitious gain for the sole purpose of restoring such deficit. The absence of such rule would permit allocation of partnership items solely for tax purposes as well as creation of fictitious items solely for such allocation, which renders the unlimited DRO requirement practically meaningless.

The prohibition against capital shifting and the "ceiling rule" can theoretically cause an allocation that has economic substance but doesn't satisfy the primary test to also fail the EEE test. Consider the following example.

Example Ten

A contributes $100X and B contributes $10X to form Partnership AB. A is a limited partner and B is a general partner having no DRO. The partnership agreement provides that, in a liquidation, (1) B is first allocated an amount that permits her to recover all invested capital and to earn a 10% return on capital; (2) A is next entitled to recover her invested capital; (3) any remaining partnership net assets are allocated 50/50 between A and B; (4) all partnership items must be allocated in accordance with the allocation of net assets in a liquidation. Since liquidating distributions are not made according to positive capital account balances, and there is no unlimited DRO for B, the allocation doesn't satisfy the primary test. An important question here is whether the allocation satisfies the EEE test as an alternative.

One argument that the EEE test is not satisfied here is that the purported allocation permits capital shifting from B to A while the primary test prohibits it. Suppose the partnership has $5X income and $5X of expenses in the first year of operation and is liquidated at year end. A will receive $110X in the liquidation and B will receive nothing, essentially shifting $5X contributed capital from B to A. Under the primary test, the maximum capital account balance of A at the time of liquidation is $105X since the partnership only has $5X actual income in the first year, and simultaneous creations of a $5X fictitious gain and a $5 fictitious loss are prohibited.

However, from an economic perspective, the $5X income and $5X loss are not entirely "fictitious" because they reflect the parties' *ex ante* assumption of actual business risks, and the consequence is not merely capital shifting. Specifically, the parties agree that B will assume the risk that the partnership will generate a net income of less than $10X, and B's concession on this issue may be necessary to induce A, a limited partner, to invest in the partnership's business. In other words, assuming arm's length negotiations, A's $10X total gain on her invested capital consists of an actual income of $5X and an "imputed" income of $5X which reflects the parties' *ex ante* expectations about the amount A would earn by investing in an alternative business with comparable risks. Accordingly, B's $10X total loss on her invested capital consists of a $5X actual loss and a $5X "opportunity cost" that A has incurred by investing in the partnership's business which B has agreed to assume.

There is also unlikely to be a tax avoidance motive here. First, the partnership agreement specifies an economic target in liquidation first and then simply requires an allocation of partnership items to reflect that liquidation target. Second, the guaranteed 10% return on invested capital seems to be a reasonable amount and consistent with A's role as a limited partner with no management rights. Thus, the allocation should be respected for tax purposes; otherwise, an efficient business arrangement may be disturbed because of an arbitrarily created disparity between pre-tax and after-tax consequences.

To fully reflect the parties' economic arrangement in tax, the Service should consider disregarding the "ceiling rule" under section 1.704-1(b)(2)(iv) in this case and treating the $5X fictitious gain and loss as if they are actually realized and recognized by the partnership. As a result, the allocation would have economic effect under the EEE test. By disregarding the "ceiling" rule in an allocation that permits capital shifting but has a *bona fide* business purpose and no tax avoidance motive, the Service would correctly treat a fictitious gain implied *ex post* as an actual economic gain expected *ex ante*, and a fictitious loss implied *ex post* as an actual cost incurred by a party to assume a business risk *ex ante*.

On the other hand, capital shifting can theoretically be used as a tax avoidance device to allocate partnership items solely for tax purposes. Consider the following example.

Example Eleven

At the beginning of Year 1, A and B each contributes $200X to form Partnership AB. A has a net operating loss (NOL) carryover that is about to expire. The partnership agreement provides that (1) in a liquidation before the end of Year 2, A is entitled to recovery of capital plus a 100% return on invested capital before B recovers capital, and any remaining net assets are shared equally between A and B; (2) in a liquidation after the end of Year 2, B is entitled to recovery of capital before A recovers her capital, and any remaining net assets are shared equally between A and B; (3) voluntary liquidation of the partnership requires mutual consent of both A and B; (4) all partnership items must be allocated in accordance with the allocation of net assets in a liquidation. The allocation obviously doesn't satisfy the primary test.

In this extreme example, there is arguably a tax avoidance motive, because a 100% return on invested capital in the first year of operation is not supported by any market reality, the partners never expect to voluntarily liquidate the partnership within the first two years of operation, and A's tax attribute (an expiring NOL carryover) unrelated to the partnership works too well with the arrangement. The sole purpose of the parties' arrangement is to create a fictitious loss for A in Year 1 and to reverse the amount in Year 2. Assuming that the partnership breaks even in both Year 1 and Year 2 with $100X income and $100X expense. At the end of Year 1, A is deemed to have received $100X actual loss and $100X fictitious loss, while B received $100X actual gain and $100X fictitious gain. At the end of Year 2, if the partnership is not liquidated, A is deemed to have received $100X actual gain and $100X fictitious gain, while B received $100X actual loss and $100X fictitious loss.

In this case, because the fictitious gain and loss are not supported by business purposes and a tax avoidance motive is obviously present, the Service should not waive the "ceiling rule" under Reg. Sec. 1.704-1(b)(2)(iv).[143] Thus, the allocation should fail the EEE test, and all partnership items must be allocated "in accordance with the partners' interest in the partnership." In this case, the Service may re-allocate the $100X income and $100X expense equally between A and B.

B. Guaranteed Payment as an Alternative to Capital Shifting

Treat the "ceiling rule" as waivable dependent on the underlying tax avoidance motive of partnership arrangement is one way to cure the problem of target allocation. Alternatively, a preferred return to a limited partner through a target allocation similar to the one in Example Ten can be viewed as a guaranteed payment, defined as payment for the use of capital without regard to partnership profitability.[144] Consequently, in Example Ten, if the preferred return is

[143] Admittedly, in this extreme case, the allocation will fail the substantiality prong of the SEE test for being "transitory" even if it's treated as having economic effect under the EEE test. *See* Treas. Reg. § 1.704-1(b)(2)(iii)(c). *See also* Example Seven, Part III.C.5, *supra*.

[144] *See* I.R.C. § 707(c); Treas. Reg. § 1.707-1(c); Treas. Reg. § 1.707-4.

a guaranteed payment, it is includible in A's gross income regardless of A's tax accounting method and deductible to Partnership AB subject to the capitalization requirement in section 263 of the Code, as if it's made to a non-partner.[145] Ignoring section 263 issues, the capital shifting problem is seemingly eliminated because Partnership AB now has a non-fictitious, legitimate $10X loss that can be allocated to B,[146] and the allocation overall satisfies the EEE test and is also in line with the partners' interest in partnership.

One may argue that the guaranteed payment should exclude the amount that represents allocation of gross income or expense such that in Example Ten, the amount of guaranteed payment is $5X rather than $10X. Assessing the validity of this argument requires one to make an assumption regarding whether the words "without regard to the income of the partnership" in section 707 of the Code is intended to have an *ex ante* or an *ex post* meaning. The Service's current position on this issue is unclear, if not contradictory. On one hand, the Service seems to adopt an *ex post* view in Example (2) of Treas. Reg. § 1.707-1(c), suggesting that to the extent a partner's distributive share of partnership income before taking into account any guaranteed payment is below an *ex ante* guaranteed minimum amount that a partner will receive, that amount is not treated as a guaranteed payment.[147] On the other hand, Example (1) of Treas. Reg. § 1.707-4(a)(4) treats a 10% preferred return on the fair market value of contributed capital as a guaranteed payment without considering the partner's *ex post* distributive share of partnership income, suggesting an *ex ante* view.[148] Yet another uncertainty lies in whether the word "income" in section 707(c) of the Code is intended to refer to partnership taxable income only.[149] Given that Treas. Reg. § 1.707-4 became effective in 2016, much latter than Treas. Reg. § 1.707-1's effective year of 1976, and that the latter has not been amended to reflect subsequent changes, one should be aware of the possibility that the Service has implicitly shifted its view from *ex post* to *ex ante* in its interpretation of section 707(c).

However, viewing preferred return on contributed capital as a guaranteed payment for the purpose of keeping an allocation (like a target allocation) in line with the SEE safe harbor requirements has received mixed attitudes from practitioners, and the law in this area is not well-developed.[150] Two questions are particularly relevant here. First, how should the

[145] Treas. Reg. § 1.707-1(c).

[146] Assuming $5X income and $5X expense in Year 1 without considering guaranteed payment.

[147] *See also* Pratt v. Commissioner, 550 F.2d 1023 (5th Cir. 1977) (holding that the payment of interest on a bona fide loan by the taxpayer-partner to the partnership is not treated as guaranteed payment).

[148] One may argue that, if a partner is entitled to a X% distributive share of *pre-guaranteed payment* partnership income with a guaranteed minimum amount of $Y, he/she may or may not be allocated any deduction taken by the partnership for such guaranteed payment, and the partnership needs to have income higher than ($Y/X%) in order for the partner to have true equity exposure. *See, e.g.,* Treas. Reg. § 1.707-1(c), Ex. (2). Thus, his/her situation is distinguished from another partner who receives a straightforward guaranteed payment of $Y plus a X% distributive share of *post-guaranteed payment* partnership income, in which case the partner is certainly allocated a portion of the deduction from the guaranteed payment, and equity exposure begins earlier (at $Y). *See, e.g.,* Treas. Reg. § 1.707-1(c), Ex. 1; Treas. Reg. § 1.707-4(a)(4), Ex. 1. These two distinctions, however, are not significant enough to override the fact that in both cases, the partner is entitled to $10,000 regardless of the partnership's economic performance.

[149] Although the Treasury Regulation is also unclear on this issue, allocation of partnership gross income and expense is permitted, if not required, at least in some circumstances. *See, e.g.*, Treas. Reg. § 1.704-1(b)(3)(i) (suggesting that allocation in accordance with partner's interest in the partnership may sometimes require a specific allocation of partnership gross income, e.g., to reverse an unexpected capital account deficit). The qualified income offset rule is another example of a required allocation of partnership gross items.

[150] *See* Terence Floyd Cuff, *Drafting and Understanding Partnership and LLC Allocation and Distribution Provisions* § 9:5 ("the law on guaranteed payments and capital shifts…is not well developed"), Guaranteed

partnership allocate deductions that result from guaranteed payments? In Example Ten, if Partnership AB allocates the $10X loss to A rather than B, the result of the hypothetical liquidation at the end of Year 1 will obviously mismatch the result under the primary test, and the EEE test is not satisfied. Second, what is the limitation (if any) on creating partnership-level gain or loss using guaranteed payments to fit an allocation into the SEE safe harbor? For example, can a partnership allocation with an obvious tax avoidance motive as in Example Eleven also be justified under the EEE test through the use of guaranteed payments? The analysis below answers each question in turn.

1. Allocation of Guaranteed Payment: Answer to the First Question

Since a guaranteed payment is treated as a transaction between a partnership and a non-partner solely for purposes of section 61(a) and 162(a), [151] it is a partnership-level deduction that can be allocated under the partnership agreement with the same flexibility and subject to section 704 Regulations.[152] Thus, a partnership may allocate some or all of the deduction from guaranteed payments to the partner receiving such payment; no special rules seem to limit this partnership-level maneuver.[153] However, in Example Ten, in order to fit the target allocation into the EEE test, the partners must provide in the partnership agreement that any deduction from preferred returns treated as a guaranteed payment must be allocated to B, i.e., the general partner.[154]

Policy wise, the same flexibility should be afforded to an allocation of deductions from guaranteed payments as that afforded to partnership allocations in general. That is, the allocation should be respected as long as the requirements under the section 704 Regulations are satisfied. For example, an allocation of the entire deduction from the guaranteed payment to the partner who receives such guaranteed payment is similar to that partner receiving a distribution. As long as a guaranteed payment is not part of a disguised transaction of something else, such as a simple capital shift or a purchase money debt, [155] section 704 Regulations should be enough to constrain the potential abuse.[156]

payments as salaries, returns on capital and minimum distributions (2018 Ed.). *See also* Goldberg, *supra* note 54 at 663, 715-16 (stating that distributions resulting from allocations made to reflect the partners' economic deal should arguably be treated as guaranteed payments, but that it is unclear what the guaranteed payment is for).

151 Treas. Reg. § 1.707-1(c).

152 By contrast, a distributive share of partnership income or gain to one partner, by definition, must reduce the distributive share of the same income or gain to other partners.

153 Allocating a distributive share of post-guaranteed payment partnership income to the partner receiving the guaranteed payment is certainly permissible. *See, e.g.*, Treas. Reg. § 1.707-1(c), Ex. 1, 3. There is no rule that limits a special allocation of guaranteed payments except for rules that limit partnership allocation overall, such as the section 704 Regulations.

154 Otherwise, the target liquidation result will mismatch that under the primary test of the SEE safe harbor. For example, if the $10X deduction from the guaranteed payment is allocated entirely to A, A's capital account balance under the primary test would be $90X while A is entitled to $100X in a liquidation without considering the guaranteed payment. Note that guaranteed payment income doesn't increase the capital account balance of its recipient-partner. *See, e.g.*, Treas. Reg. § 1.707-4(a)(4), Ex. (2)(iv).

155 For an example of disguised purchase money debt, see Treas. Reg. § 1.707-4(a)(4), Ex. 2.

156 See discussion below for transactions disguised as guaranteed payments.

2. *Limitation on Using Guaranteed Payment to Satisfy the SEE Safe Harbor: Answer to the Second Question*

As discussed in Part IV.B.1, although a deduction from a guaranteed payment should be permitted to be allocated like a regular partnership-level deduction, there should not be unlimited ability to designate any payment by a partnership to a partner that is not based on partnership income as a guaranteed payment.[157] As the extreme cases in Example Eleven and Example Twelve (below) show, such unlimited ability is equivalent to a repeal of the implied "ceiling rule" under the section 704 Regulations and significantly undermines the goal that the SEE safe harbor is intended to achieve.

Example Twelve

A and B each contributes $100X cash to form Partnership AB. The partnership purchases equipment for $100X and keeps $100X cash. A and B's partnership agreement provides that (1) capital accounts are maintained according to the section 704 Regulations; (2) liquidating distributions are made according to positive capital account balances; (3) each partner has an unlimited DRO; (4) all partnership items are allocated equally except that all depreciation from the equipment is allocated to A; (5) in the year of liquidation, A is entitled to a 50% preferred return on initially invested capital that is designated as a guaranteed payment, and the partnership-level deduction from such guaranteed payment is specifically allocated to B. Assuming that the partnership breaks even each year except for depreciation, the equipment's value at liquidation is equal to its adjusted book value, and Partnership AB is liquidated after the equipment is fully depreciated.

As the reader might have already noticed, the partners in Example Twelve intend to achieve a goal similar to what the Orrischs in *Orrisch v. Commissioner* tried to achieve, but through a different route.[158] To be sure, A and B's partnership agreement satisfies the primary test of the SEE safe harbor perfectly, but nonetheless contains the same abuse that the SEE safe harbor is intended to address. The "last-minute" guaranteed payment ensures that the partners will share the partnership net assets equally at liquidation, but all depreciation from the equipment is allocated to A for tax purposes. The net effect is what the *Orrisch* court described as a "trade of tax consequences."[159] Like Example Eleven, the tax avoidance motive here is obvious, as a 50% preferred return on capital is devoid of any business reality and works too well with the special allocation of depreciation to reduce the parties' tax liability in present value terms. Consequently, the guaranteed payment is being used here to disguise a simple capital shift from B to A which is otherwise prohibited under the section 704 Regulations.

One possible response to this problem that the reader might have is that the economic effect of allocation of the depreciation deduction is not "substantial" for being "transitory"

157 *See* Cuff, *supra* note 150. According to Cuff, "there is substantial doubt that a partnership can provide economic effect to its allocations simply by providing for guaranteed payments on liquidation equal to the excess of the amount that a partner receives on liquidation over the amount in his "book" capital account."

158 *See supra* note 17 and accompanying text.

159 *See supra* note17. Admittedly, the partnership agreement may fail the substantiality prong of the SEE safe harbor if the special allocations of depreciation and deductions from guaranteed payments are viewed as "transitory". However, if there is a "strong likelihood" that liquidation will not occur within five years, the allocations will not be deemed "transitory." *See* Treas. Reg. § 1.704-1(b)(2)(iii)(c); Treas. Reg. § 1.704-1(b)(5), Ex. 2.

since it is exactly offset by the guaranteed payment.[160] There are two potential issues related to this response. First, it can be hard to argue that the guaranteed payment is an "offsetting allocation" especially since the regulations specifically require A to include the guaranteed payment as ordinary income and the partnership may be able to deduct it, and this is exactly what happens here.[161] Second, even if the guaranteed payment is technically an "offsetting allocation," A and B can avoid the substantiality problem by utilizing the "five-year" safe harbor provided in the regulations.[162] And unlike a "charge-back" of potential future profit,[163] satisfying the "five-year" rule does not make the over arrangement significantly less abusive, as a guaranteed payment is, as the words indicate, "guaranteed."

3. A Summary of the Capital Shift Discussion So Far

As a summary of the above discussion on capital shifting, the section 704 Regulations contain an implied "ceiling rule" that prohibits simple capital shifting among partners through the partnership agreement. Thus, a partnership allocation that permits simple capital shifting cannot satisfy the EEE test. However, the Service should distinguish between a *bona fide* preferred return (Example Ten) from a simple capital shift (Examples Eleven and Twelve) by looking into factors such as the presence of a tax avoidance motive as well as business reality. A *bona fide* preferred return should be treated as a guaranteed payment, which is equivalent to an exemption from the "ceiling rule," while a simple capital shift disguised as guaranteed payment must be viewed for tax purposes based on its substance rather than form.

4. Book-Equal-to-Value Assumption: Revisited

Another uncertainty in the application of the EEE test is whether book value or fair market value should be used in determining the deemed liquidation amount in a current or future hypothetical liquidation. The EEE test does not explicitly contain a value-equals-basis assumption, and the current law on this issue is not clear. It might be argued that since a liquidation under the Treasury's capital account approach is based on fair market value,[164] the EEE test permits or even requires a comparison of liquidation results on a revalued basis.[165] Such argument seems to be misconceived in two ways. First, if the partnership does not in fact revalue its properties during the taxable year such that the allocation of revaluation, gain or loss is not an issue, since the EEE test requires a matching of liquidation results in a current or future liquidation "regardless of the economic performance of the partnership,"[166] and a value-equals-basis assumption does not seem to change the result. Since book value itself should cover all possible economic performances in the future, a revaluation solely for purposes of the EEE test is unnecessary. Second, if the partnership in fact revalues its properties, in order to determine whether the allocation of revaluation items satisfies the EEE test, one only needs

[160] *See* Treas. Reg. §1.704–1(b)(2)(iii)(C).
[161] Treas. Reg. §1.707-1(c).
[162] Treas. Reg. §1.704–1(b)(2)(iii)(C) (flush language).
[163] *See* Treas. Reg. §1.704–1(b)(5), Ex. 8.
[164] *See* Treas. Reg. §1.704–1(b)(2)(iv)(f)(5)(ii) (a liquidation is a revaluation event).
[165] *See, e.g.*, NYSBA TAX SECTION, *supra* note 102 at 32-33.
[166] Treas. Reg. §1.704–1(b)(2)(ii)(i).

to compare the liquidation result under the partnership agreement, taking into account the new book basis and the new capital account balances after adjustments for revaluation in accordance with the regulations, with the result under the primary test.

V. CONCLUSION

Unlike many other facets of federal tax law, efficiency considerations do not seem to have played an important role in the analysis of Subchapter K. However, an arbitrary tax policy under Subchapter K has the same potential of imposing efficiency costs on society. While the Treasury has elected to use capital accounts as a measurement of the partners' economic arrangement, its "one-size-fits-all" approach may not work well in complex partnership deals. To improve the efficiency of Subchapter K, the Treasury should attempt to clear up the current regulatory uncertainty under section 704 regulations and should consider establishing a safe harbor approach for non-abusive partnership allocations that do not follow the Treasury's capital account approach.